

THE NEW REGIONALISM IN LATIN AMERICA

The dual forces of globalization and regionalization were very much at work during the 1990s. Globalization was in fact quite evident in the sharply increasing participation of international trade, finance and foreign direct investment flows in the world product, the strong presence of multinational corporations, and the increasing importance of immigration flows and worker remittances to their home countries (Table 2.1). Alongside this globalization process was increasing evidence of regionalization. While limitations on data make it more difficult to fully document regionalization, the picture emerges very clearly in trade. Regional patterns of international trade have been steadily growing. By the end of the 1990s, two-thirds of European merchandise trade was with European countries, while the comparable figures for the Asian-Pacific and Western Hemisphere were 40 percent and 50 percent, respectively (Table 2.2).

The centrifugal forces of globalization and the centripetal dynamics of regionalization may at first blush appear contradictory. However, they are increasingly interpreted as complementary forces of private market development (Oman, 1998). Indeed, the two processes are being driven by many of the same factors. Advances in the technology of transport, communications, information and other areas have rapidly extended the global reach of market activity, just as they did in the 19th century.

The process of globalization is in fact far from a new phenomenon. Economists have identified the early 19th century as the start of globalization, interrupted by the Great Depression but renewing itself in

the post-war period. Then, as well as now, there was a sustained and marked increase in the international flows of goods, capital and people. Indeed, some flows such as labor migration were far superior than today, while it took much of the post-war period for capital and trade flows to exceed those recorded a century earlier (Williamson, 1997; Rodrik, 1997; and Crafts, 2000). At the same time, the post-war evolution of production technology has increased the relative demands for flexibility, timely supply, and decentralized responses to demand and tastes. This also creates economies of agglomeration that have encouraged regionalization of production, even for firms with a global strategy (Oman, 1998; Humphrey and Schmitz, 2000).

Policy also has been driving the dual forces of globalization and regionalization. Post-war unilateral liberalization and deregulation, as well as successive multilateral rounds in the General Agreement on Tariffs and Trade (GATT), have freed global trade and finance from the administrative restrictions of the inter-war period, while legal (and varying degrees of tolerance for illegal) cross-border movement of people has noticeably increased immigrant participation in many workforces.

Deliberate policy also has driven regionalization. An increasing number of countries are relying on formal regional integration to mediate the forces of globalization. During the 19th century, nation states mediated the global economy directly. However, the collective economic turmoil of the inter-war period induced countries to cooperate and lay the groundwork for the creation of the multilateral system that we

Table 2.1 Globalization Indicators, 1970-99

Indicator	1970	1980	1990	1999
Trade (% of GDP)				
OECD	25.6	39.5	37.1	41.1
Africa	49.9	60.1	52.6	61.3
Asia	10.2	26.2	38.3	53.5
Latin America ¹	22.3	30.2	28.4	35.6
Capital flows				
Gross private capital flows (% of GDP, PPP)				
World	...	6.3	8.3	18.3
High-income OECD	...	7.1	11.8	28.2
Latin America	...	4.7	3.9	7.3
Gross foreign direct investment (% of GDP, PPP)				
World	...	1.0	2.2	4.6
High-income OECD	...	1.3	3.3	7.0
Latin America	...	0.6	0.4	3.0
Memorandum item				
Gross value of foreign capital stock (% of GDP)				
Developing countries ²	10.9	21.7
Migrations and remittances				
Migration flows				
European Union immigration rate ³	2.4	1.5	2.8	2.4
U.S. immigration rate ⁴	...	2.1	3.1	3.6
U.S. population percentage Hispanic or Latino	...	6.4	9.0	12.5
Receipts of workers' remittances (balance of payments, % of GDP)				
Latin America	...	0.2	0.4	0.7

¹ Latin America corresponds to the Western Hemisphere definition of the IMF.

² The figure for 1970 refers to 1973; the figure for 1999 refers to 1998. See Maddison (2001).

³ Net migration is estimated on the basis of the difference between population change and natural increase (corrected net migration). Annual rate is per 1,000 EU population. The figures for 1960 to 1980 refer to EU-10.

⁴ The annual rate is per 1,000 U.S. population; 1980 refers to 1971-80; 1990 refers to 1981-90; 1999 refers to 1991-98.

Sources: IDB calculations based on World Bank (2001); U.S. Bureau of the Census; Eurostat; and IMF data.

know today, which is designed to promote an international environment conducive to more stability and to expand participation in the world economy (James, 2001). This was further complemented by a web of bilateral agreements between countries covering any number of issues. But as the forces of globalization have gathered force, there have been additional policy responses. These have included decentralization in administration by nation states (IDB, 1997), which has allowed local adaptation to the challenges of globalization, and formal regional integration initiatives.

Although regional integration initiatives have a long history in the world economy, there has been a remarkable expansion of this activity in recent years, especially since 1990. Between 1948 and 1979 some 54 regional integration initiatives were notified to the GATT, then another 15 during the 1980s. However,

during the 1990s there was a virtual explosion of new agreements that dwarfed past notifications (Figure 2.1). While there are various reasons for pursuing regional integration, many can be summarized as steppingstones to more effective participation in the multilateral trading system and a globalizing world economy.

REGIONAL INTEGRATION IN LATIN AMERICA

At the level of policy, the Latin American and Caribbean region has simultaneously pursued the global and regional paths. Sparked by the economic crisis of the 1980s, the region began to undertake ambitious structural reforms. These included unilateral policies to open up economies to the rest of the world

Table 2.2 Intra-regional Trade Shares, 1980-2000

(Percentage of intra-regional trade/total trade)

Region	1980	1990	1999	2000
Asia Pacific Cooperation Forum (APEC) ¹	55.1	63.8	68.4	68.6
European Union and Eastern Europe ²	57.5	65.6	66.1	64.2
European Union	57.2	64.5	62.0	60.0
Western Hemisphere	44.6	44.1	53.0	53.3
Asia Pacific ³	33.4	32.9	38.9	40.6

Note: Intra-regional trade shares are simple averages.

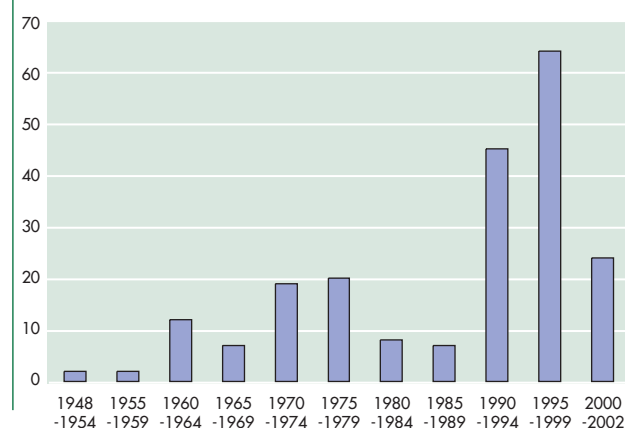
¹ Includes Australia, Brunei, Canada, Chile, People's Republic of China, Hong Kong, Indonesia, Japan, Republic of Korea, Malaysia, Mexico, New Zealand, Papua New Guinea, Peru, Philippines, Russia, Singapore, Chinese Taipei, Thailand, United States and Vietnam.

² Includes the European Union plus Bulgaria, Czech Republic, Hungary, Poland, Romania and the Slovak Republic (Czechoslovakia replaces the Czech and Slovak republics prior to 1993).

³ Includes Brunei, Singapore, Thailand, Malaysia, Indonesia, Philippines, Cambodia, Laos, Myanmar, Vietnam, China, Japan, Korea, Australia and New Zealand.

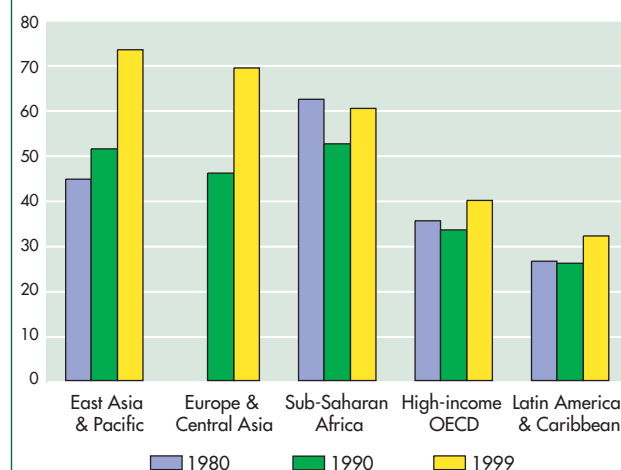
Source: IDB calculations based on IMF (2001).

Figure 2.1 Number of Regional Agreements Notified to GATT/WTO, 1948-2002



Note: The data consist of agreements that have notified to GATT/WTO under Article XXIV and under the Enabling Clause. Some agreements included are no longer in force. Accessions to existing agreements are counted in their own right. The data are organized by year of entry into force of the agreement. Source: WTO Secretariat.

Figure 2.2 Openness Coefficient (Trade as a percent of GDP)



Note: The openness coefficient is a simple average. Source: World Bank (2001).

and deregulate them in order to provide more space for private sector activity. As an illustration, average tariffs in the region declined from over 40 percent in the mid-1980s to about 12 percent in the mid-1990s. This was combined with participation in the multilateral Uruguay Round and assumption of its very comprehensive disciplines. The region complemented this global opening with a web of new regional integration initiatives—nearly 30 since 1990, ranging from free trade areas to customs unions with ambitions of becoming a common market. Any number of other agree-

ments are in different stages of negotiation (Table 2.3).

These trade policies are reflected in trade performance. The global opening of the region's economies contributed to average annual growth of extra-regional trade exceeding the expansion of world trade (10.8 percent vs. 6.6 percent) in the 1990s,¹ with growth of imports notably faster than that of exports

¹ Without Mexico, Latin America's extra-regional trade was 7.8 percent.

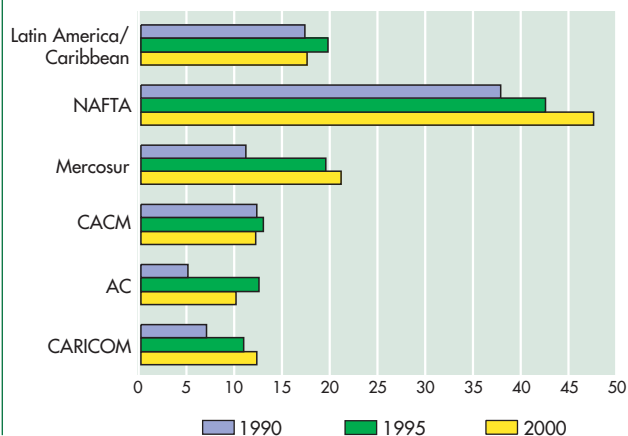
Table 2.3 Latin American Integration Agreements

	Date of signature
Intra-regional Free Trade/ Customs Union Agreements	
Central American Common Market (CACM)	1960 ¹
Andean Community (AC)	1969 ¹
Caribbean Community (CARICOM)	1973 ¹
Southern Cone Common Market (Mercosur)	1991
Chile-Venezuela	1993
Colombia-Chile	1994
Costa Rica-Mexico	1994
Group of Three (G-3)	1994
Bolivia-Mexico	1994
Chile-Mercosur	1996
Bolivia-Mercosur	1996
Mexico-Nicaragua	1997
CACM-Dominican Republic	1998 ²
Chile-Peru	1998
Chile-CACM	1999
Chile-Mexico	1999
Mexico-Northern Triangle of Central America	2000
CARICOM-Dominican Republic	2000
Costa Rica-Trinidad and Tobago	2002 ²
El Salvador-Panama	2002 ²
North-South Agreements	
Mexico: NAFTA	1992
Chile-Canada	1996
Mexico-European Union	1999
Mexico-EFTA	2000
Mexico-Israel	2000
Costa Rica-Canada	2001 ²
Chile-European Union	2002
Negotiations in Progress	
Intra-regional Free Trade Agreements	
Mercosur-AC	
Costa Rica-Panama	
Mexico-Panama	
Mexico-Peru	
Mexico-Ecuador	
Mexico-Trinidad and Tobago	
North-South Agreements	
Free Trade Area of the Americas (FTAA)	
Mercosur-European Union	
Chile-EFTA	
Chile-United States	
CARICOM-European Union (post-Cotonou reciprocal arrangements)	
Central America-4-Canada	
CACM-United States	
Uruguay-United States	
Mexico-Japan	
Chile-South Korea	
Others	
Brazil-China	
Brazil-Russia	

¹ Relunched in the 1990s.

² Awaiting ratification.

Figure 2.3 Intra-subregional Trade Share
(Percent of total trade)



Notes: Percentage represents a simple average.

Source: IDB calculations based on IMF (2001).

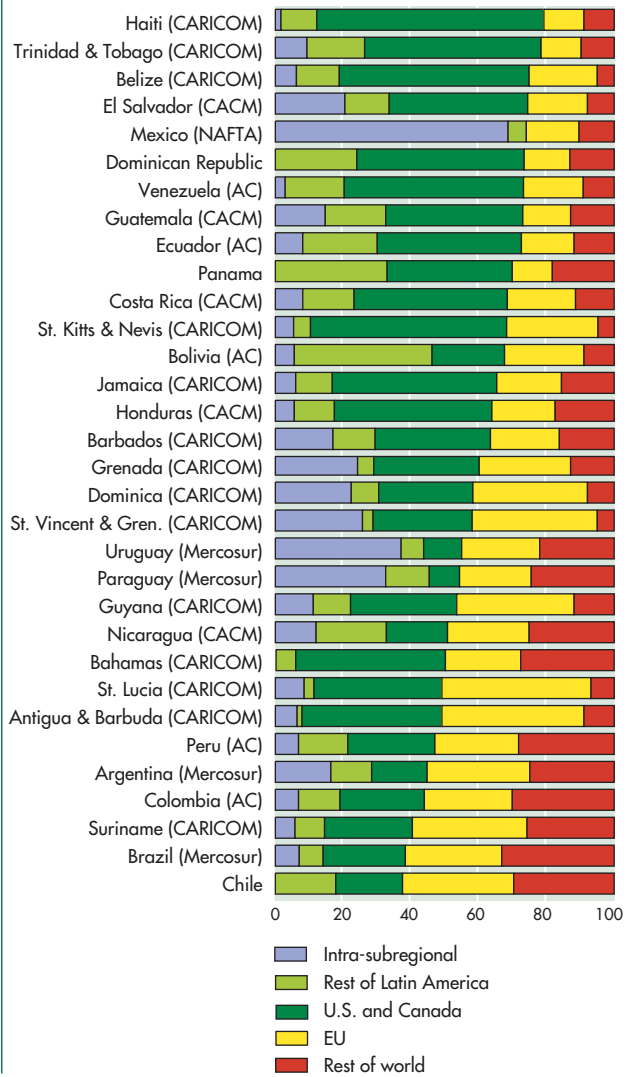
(12 percent vs. 9.7 percent) (IDB, 2000). Figure 2.2 shows that the region's openness coefficient also rose over the same period, but is still very low relative to other trading areas.

Pointing up the regionalization of trade, Latin American subregional trade grew considerably faster than extra-regional trade (Figure 2.3). Comparing 1990 to 2000, Figures 2.4 and 2.5 show a marked increase in the relative importance of intraregional trade, with subregional trade agreements being the primary vehicle for the countries that are members of them. Box 2.1 summarizes the main characteristics of the subregional integration agreements and Box 2.2 provides a more detailed review of the Caribbean Community (CARICOM) as an illustration of the deep integration objectives that characterize all the Latin American initiatives.

Incorporating the North American market into the picture shows that its importance for Latin America also was on the rise in the 1990s. On the whole, then, the relative importance of the Western Hemisphere in the region's trade increased, largely at the expense of the European Union (EU).² Hence, the 1990s exhibit a clear pattern of intensifying regionalization of Latin American trade. Meanwhile, Brazil, Chile and a few

² For a more detailed analysis, see IDB (2002).

Figure 2.4 Geographical Composition of Trade Flows, 1990
(Percent of total trade with selected countries or regions)

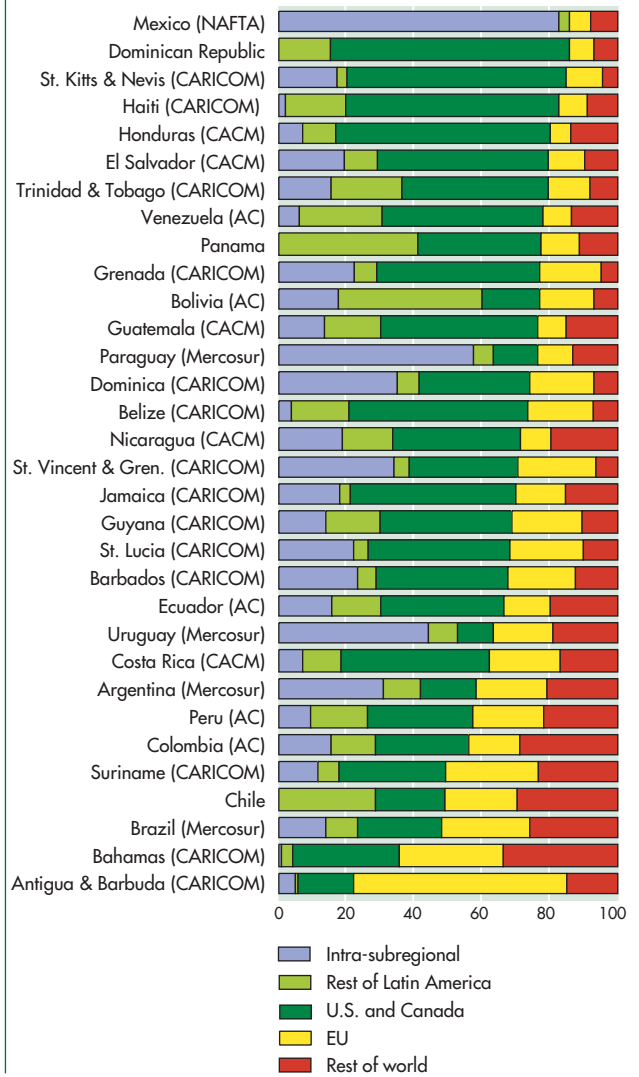


Source: IDB calculations based on IMF (2001).

CARICOM countries display a pattern of a more global character.

Many factors have driven the regionalization of Latin America. They include the unilateral opening of economies, which exposed borders and allowed for the natural pull of geography and common culture and tastes to take hold. But policy-induced regionalization, or regionalism, has also played a role through the aforementioned creation of regional integration agreements that have provided for, among other things, pref-

Figure 2.5 Geographical Composition of Trade Flows, 2000
(Percent of total trade with selected countries or regions)



Source: IDB calculations based on IMF (2001).

erential elimination of tariffs among partners and more secure market access than that which is offered by the rest of the world.

Regionalization has gone beyond trade. While data are extremely limited and values relatively low compared to extraregional flows, there are indications of increased intra-Latin America investment flows during the 1990s (Garay and Vera, 1998). Meanwhile, NAFTA has been a magnet for U.S. foreign direct investment (FDI). Mexico experienced a marked

Box 2.1 Main Subregional Integration Agreements in the Americas

Andean Community

Members: Bolivia, Colombia, Ecuador, Peru and Venezuela.

Established: The Cartagena Agreement was signed by Bolivia, Chile, Colombia, Ecuador and Peru in May 1969. Venezuela acceded in February 1973 and Chile withdrew in October 1976.

Goals: The founding agreement envisaged an Andean customs union as a step towards the creation of a Latin American common market. During the latter half of the 1970s, the integration process lost momentum and was revived in the 1990s when member countries re-launched a common market project. They completed the free trade area by 1992 and agreed on the implementation of a common external tariff. In 1996, the newly institutionalized Summits of the Andean Presidential Council gave fresh impetus to the process and set the stage for the adoption of the Trujillo Protocol that created the Andean Community (it was the Andean Group until then) based on a new functional and more modern institutional structure. Along with institutional renewal, the parties progressively agreed on a timetable for the reincorporation of Peru into the free trade area (suspended since 1992), committed to creation of a common market by 2005, and started the negotiation of a new four-tier common external tariff expected to be in place by the end of 2003.

Status: The Andean Community is one of the most institutionalized regional agreements among developing countries. The intra-regional Trade Liberalization Program ended in the completion of the free trade area between Bolivia, Colombia, Ecuador and Venezuela in 1993. Internal free trade applies across the board on the entire universe of tariffs. Peru has been implementing a liberalization program since 1997 that aims at unrestricted internal free trade by 2005. The common external tariff (CET) that entered into force in 1995 between Colombia, Ecuador and Venezuela is structured in four tariff levels (5, 10, 15 and 20 percent) with a nominal average rate of 13.6 percent. Individual countries are allowed to diverge from the CET in certain products, while sectoral exceptions are determined by the implementation of special regimes in the agriculture and the automotive sectors. Some progress on macroeconomic coordination is reflected in the setting of convergence targets for inflation and the public deficit.

Central American Common Market (CACM)

Members: Costa Rica, El Salvador, Guatemala, Honduras and Nicaragua.

Established: The General Treaty on Central American Economic Integration was signed by Guatemala, Honduras, El Salvador and Nicaragua in December 1960. Costa Rica acceded in July 1962.

Goals: The general treaty envisaged the creation of a common market, originally scheduled to come into effect within five years of the agreement's entry into force. After an extremely promising first decade of integration, the process became strained by political conflicts in the member countries and by the debt crisis. It was revived in 1993 with the subscription of the Guatemala Protocol, which provided new foundations for economic integration in the framework of the Central American Integration System. The protocol introduced the principles of gradualism, progressivity and flexibility in the achievement of the full integration of the CACM. Building on these criteria, the members subscribed an agreement for the implementation of a customs union by the end of 2003. Belize and Panama have joined the political body of the integration system.

Status: Most intra-regional trade is tariff-free, with the common exception of coffee and sugar and a few other exceptions in the bilateral trade of agricultural goods. El Salvador, Guatemala and Honduras have set up joint customs facilities, and the Puebla-Panama Plan contemplates further simplification of border procedures, the removal of non-tariff barriers in phytosanitary controls and technical standards, and greater integration of infrastructure. Member countries have agreed to a four-tier tariff schedule (0, 5, 10, and 15 percent), with some sectoral and national exceptions and an average level of about 7.5 percent. About 80 percent of the common external tariff has been implemented.

Latin American Integration Association (ALADI)

Members: Argentina, Bolivia, Brazil, Chile, Colombia, Cuba, Ecuador, Mexico, Paraguay, Peru, Uruguay and Venezuela.

Established: The 1980 Treaty of Montevideo established ALADI as a successor to the Latin American Free Trade Association (LAFTA).

Goals: To increase bilateral trade among member countries and between members and third countries through bilateral and multilateral agreements. The treaty envisaged an economic preference area for goods from member states and partial agreements

aimed at fostering economic complementarity, trade promotion, agricultural commerce, and scientific and technological cooperation.

Status: Currently, 40 partial scope agreements involving two or more countries are in force in the ALADI framework, most of which were signed in the 1990s.

North American Free Trade Agreement (NAFTA)

Members: Canada, Mexico and the United States.

Established: The agreement was signed in December 1992, ratified by the three national legislatures in 1993, and entered into force in January 1994.

Goals: NAFTA aims to eliminate trade barriers, facilitate the cross-border movement of goods and services between the countries, promote fair competition in the free trade area, substantially increase investment opportunities, and provide effective protection and enforcement of intellectual property rights. Import duties on virtually all goods will be eliminated by 2008 at the latest. NAFTA is supplemented by two additional side agreements on environmental and labor standards.

Status: The trade liberalization program has been implemented according to schedule, or earlier. An April 1998 meeting of the Free Trade Commission agreed to remove tariffs on some 600 goods as of August of that year, thereby eliminating many tariffs 10 years earlier than originally envisaged. Over 90 percent of goods are currently tariff-exempt.

Southern Cone Common Market (Mercosur)

Members: Argentina, Brazil, Paraguay and Uruguay.

Established: The four member states signed the Treaty of Asunción in March 1991.

Goals: The integration of the members states into a common market through the free circulation of goods, services and factors of production; adoption of a common external tariff and a common trade policy; coordination of macroeconomic and sectoral policies; and legislative harmonization in areas conducive to stronger integration.

Status: The Trade Liberalization Program progressively, linearly and automatically lifted intra-regional tariffs establishing a free trade area, with significant exceptions, in 1994. Moreover, a common market project was established with completion of internal free trade by 2000, a goal that has been delayed due to serious economic difficulties in the member countries. A common external tariff (CET) organized in 11 tiers with tariff rates ranging from 0 to 20 percent and an average level of 13.5 percent entered into force in 1995. The CET is imperfect, as there was a phase-in for selected national exceptions. Moreover, special customs regimes apply to the sugar and automotive sectors, although the latter has entered Mercosur under conditions still being negotiated. Common regional provisions covering trade in services, safeguards, anti-dumping and dispute settlement have been approved but only partially implemented. In 2000, the Common Market Council (CMC), the executive body of the Mercosur, agreed on a working program focused on the lifting of residual market access barriers. National exceptions to the CET were extended until December 2002. In 2001, the CMC allowed Argentina to exceptionally and temporarily derogate the application of the CET until December 2002.

increase in flows from North America, which averaged more than \$6 billion annually between 1994 and 1999, compared to about \$2 billion in the years preceding that (López-Cordoba, 2001; ECLAC, 1998). Labor migration to the United States from Latin America has been growing significantly. So have workers' remittances to south of the border; indeed, for a num-

ber of Latin American countries, worker remittances are a more important source of foreign exchange than FDI or aid flows (MIF, 2001). There has also been increasing regionalization of functional cooperation arrangements, a topic that will be examined later in this and other chapters.

Box 2.2 The CARICOM Single Market and Economy: Current Status and Pending Issues

Members: Antigua and Barbuda, the Bahamas, Barbados, Belize, Dominica, Grenada, Guyana, Haiti, Jamaica, Montserrat, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Suriname, and Trinidad and Tobago.

In 1989, the members of the Caribbean Community (CARICOM) agreed to create a CARICOM Single Market and Economy (CSME) that entailed the removal of obstacles to trade in goods and services; the free movement of skilled persons; the end of restrictions on capital movements; a common external tariff (CET) and common trade policy; and greater coordination in other areas of economic policy. Nine modifying protocols to the CARICOM's founding treaty aim to facilitate completion of the CSME. These cover its Institutional Framework (Protocol I); Establishment, Provision of Services and Movement of Capital (II); Industrial Policy (III); Trade Policy (IV); Agricultural Policy (V); Transport Policy (VI); Disadvantaged Countries, Regions and Sectors (VII); Competition Policy (VIII); and Dispute Settlement (IX). Four of the protocols have entered into force (I, II, IV and VII) and three (III, V and VI) are being applied provisionally by most members. Most countries have signed Protocols VIII and IX, but only one has applied them provisionally.

The process of institutional change mandated under Protocol I has been completed and CARICOM's new political and policy-making bodies have been operational since 1997. Intra-regional trade in goods is virtually free: all tariffs and most unauthorized quantitative restrictions have been removed. Trade is affected by some revenue replacement taxes and by authorized exemptions from the free trade regime. Protocol VIII permits anti-dumping actions and the CARICOM Secretariat is drafting model legislation for those countries that lack a modern anti-dumping law. Export subsidies, now prohibited, must be removed before 2003. Efforts have been made to harmonize national customs laws, but member states have yet to implement the corresponding legislation. CARICOM has instituted a regime governing common standards for trade in goods, and is establishing a Caribbean Regional Organization for Standards and Quality (CROSQ).

The CET is fully implemented in 10 of 15 countries, with several national exceptions. Additionally, maintenance of a common tariff on third country imports is affected by the right of member states to negotiate bilateral trade agreements with third countries. Protocol

IV lessens the flexibility for bilateral initiatives by obliging members that negotiate such accords to seek the approval of the Council for Trade and Economic Development when tariffs are being negotiated. CARICOM nationals engaged in industrial, commercial and professional non-wage activities are accorded the right of establishment anywhere in the CSME. Member states are to remove all obstacles in this area by 2005. The same deadline applies to the full liberalization of intra-regional services trade. In linking intra- and extra-regional policies, Protocols II and IV have extended CARICOM's capacity to devise and apply joint policies on trade in goods and services. Members have created a joint mechanism for external trade negotiations, the Regional Negotiating Machinery (RNM).

As regards the free movement of capital, Protocol II foresees the removal of restrictions on banking, insurance and other financial services, and on capital and current transactions, as well as greater coordination of foreign exchange policies. Some progress has been made on the cross-listing and cross-border trading of securities on stock exchanges in the region; on reducing or abolishing exchange controls; and on upgrading stock exchanges to facilitate trading and settlement. The free movement of people is limited to certain professional categories. The need for university graduates, media professionals, artists, musicians and athletes to obtain work permits is to be eliminated by 2003. Member states have agreed to establish a CSME accreditation system with harmonized standards for certification, mutual recognition of qualifications, and a regional accreditation body. An agreement on the transfer of social security benefits entered into force in 1997, but not all countries have enacted the corresponding legislation. A CARICOM identity card is to be issued by 2003 for all intra-regional travel.

Member countries have sought to harmonize regulatory frameworks. Efforts are also being made to enhance coordination on fiscal, industrial, agricultural and transport policies. Success will depend partly on CARICOM's ability to mobilize the necessary technical and financial resources. Financing is also needed to establish a fund to assist the less developed countries and to effect other institutional changes such as the creation of the Caribbean Court of Justice (CCJ), a competition commission (to ensure adherence to business rules), and the various legal bodies envisaged under the new dispute settlement mechanism.

THE NEW VERSUS THE OLD REGIONALISM

The contemporary wave of regionalism has been coined the “new regionalism” (Ethier, 1998; ECLAC, 1994).³ However, regionalism itself is not new for Latin America. In fact, some of the first initiatives after many countries gained independence involved proposals for political union. There also are a number of historical attempts at economic integration. Indeed, this latter type of regionalism was quite widespread in the early post-war period, with the formation of ambitious initiatives such as the Latin American Free Trade Association (South America plus Mexico), which evolved into ALADI, the Central American Common Market, the Andean Group (a common market project that evolved into the Andean Community) and the Caribbean Free Trade Association (later CARICOM, also a deep integration project).

What is new about the current wave of regionalism is the objectives, modalities and outcomes. This can be seen by contrasting the stylized facts of the pattern.

The Old Regionalism

Latin America led the way with import-substitution industrialization (ISI) development strategies that dominated early post-war development policy and theory. This approach had its seeds at the start of the 20th century in some variations of the then dominant liberal economic policy, but gained full expression in the Great Depression when private markets and international trade and finance collapsed and governments throughout the world dramatically raised protectionist barriers. In the face of these developments, Latin American countries also raised their barriers and governments undertook a much more direct role in the economy in order to stimulate investment and growth during these difficult years.

The post-war arguments for an ISI strategy developed out of some prevailing assumptions, many of which had profound roots in the experience of the Great Depression. These included pessimism about the secular trends in the external terms of trade for commodity exporters; skepticism about the entrepreneurial vocation of the private sector; faith in the effectiveness of public enterprise and state planning; fear of dependence on foreign firms and their extraction of exploitative

rents; and marginal interest in the GATT and the multilateral trading system (only eight Latin American countries were members during the 1950s, and that number increased only to 11 by the end of the 1960s).

On the basis of these assumptions, development strategies promoted infant industries behind high levels of external protection, deployed state economic planning with a leading role for public enterprises in strategic sectors, and demanded regulation of FDI.

While the world economy began to rebuild itself in the early post-war period with gradual processes of liberalization and recovering flows of international trade and finance, Latin America’s growth performance began to flag, initially for the smaller economies and later for the others. But the development model, perhaps victim of its own success, was not fundamentally questioned.⁴ Rather, the prevailing diagnosis of the time was that the small domestic markets had exhausted possibilities for efficient ISI and there was a need for a larger market environment in order to achieve the efficiencies of economies of scale, especially in heavy industries that were at the core of this strategic approach.

In the development debate, regional integration emerged as one of the potential strategic tools for strengthening ISI. Oversimplifying, the approach aimed to eliminate trade and investment barriers among partner countries, maintain or even raise protection against third parties, extend planning and state intervention to a regional level, regulate foreign direct investment, and support all of this with a collective institutional architecture in which the emerging European integration project was a clear point of reference.

The results of these early regional economic integration initiatives were generally limited in terms of sustained regional tariff liberalization and trade and investment flows, with Central America being something of an exception for a while. By the mid-1970s, the processes showed very clear signs of fatigue. Some of the key obstacles included:

³ It was ECLAC that first documented the new approach to regionalism under the logo of “open regionalism.”

⁴ As Diaz-Alejandro (1985) has pointed out, while New York was enduring the Great Depression, the mills were humming in São Paulo.

- *The tendency for national protectionism.* The opening up of a regional market was handicapped by the national protectionism inherent in the model. Hence, regional liberalization was generally carried out by a laborious “positive lists” approach, often with results of limited scope. In effect, the strategic tool of regional integration was undermined by the very model that it was designed to rescue.

- *Tension between the state and the private sector.* On the one hand, this reflected extensive state intervention in market decisions, and on the other, the protectionist habits of the private sector. The tension was further aggravated by the top-heavy regional institutions that some of the agreements engendered.

- *Macroeconomic instability.* The ISI model was inherently unbalanced and prone to aggravate macroeconomic instabilities, as it placed heavy demands on capital and intermediate goods imports without a corresponding generation of exports. This was aggravated by unstable commodity prices and financial flows.

- *Distribution of benefits.* Uneven trade balances among partners created serious political tensions in the agreements.

- *Infrastructure.* Sparse regional infrastructure was a limiting factor for growth of regional trade.

- *Authoritarian governments.* The period was dominated by authoritarian governments that stimulated national rivalries, border conflicts and restrictions on the flow of goods, people and development of regional infrastructure.

- *U.S. skepticism.* The U.S. government was not comfortable during this period with regional approaches, as its focus was exclusively on the multilateral system.

The New Regionalism

The onset of the debt crisis in the early 1980s was a deathblow for the flagging ISI approach to development and the already faltering integration schemes that were introduced to support it. Once again, crisis was the handmaiden of a major shift in Latin America’s development paradigm. The region’s economic collapse of the 1980s was localized as the world economy continued to expand and world markets remained open. Moreover, by then, there were clear demonstra-

tion effects in the OECD countries and in Asia of the growth potential from opening markets and exports to the world economy. Under the pressure of a prolonged economic collapse and a shifting policy consensus, the region embarked on another historic venture involving the major structural economic reforms mentioned earlier.

The defining difference between the new regionalism of the 1990s and earlier post-war experiences was the policy environment. In effect, the new regionalism was inserted into a framework of policy reform that promotes open and competitive private market-based economies in a modern democratic institutional setting. Indeed, the new regionalism was an extension of that very structural reform process that got underway in the mid-1980s (Ethier, 1998; Devlin and Estevadeordal, 2001).

Perhaps the most dramatic change in character was the gradual shift during the 1990s from the traditional intra-regional focus for integration (“South-South”) to growing interest in inter-regional (“North-South”) agreements that commercially link industrialized countries in reciprocal free trade, often in conjunction with ambitious functional cooperation programs (Table 2.3). This would have been politically inconceivable before the new policy framework that emerged in Latin America. The new regionalism is generally viewed as having the following objectives:

- *Strengthening structural economic reforms.* The overarching motive of the new regionalism is to create a strategic policy tool to reinforce the structural economic reform process in a period of highly competitive globalization. Countries now value greater participation in the world economy as a way to stimulate investment and growth. Regional integration is viewed as an additional policy tool to complement and strengthen national reform processes. The clearest link to the structural reform process is enhancement of commitments to trade liberalization, which has been a central feature of many developing countries’ development strategies. As will be analyzed in detail in Chapter 3, regional economic integration has become the final tier of a mutually reinforcing three-tier process that also includes unilateral and multilateral openness. Regional trade liberalization has overcome many of the credibility problems of the old regionalism by working in tandem with unilateral and multilateral openness, and

Table 2.4 Manufacturing Exports, 1980–2000

(As a percent of intra- and extra-regional total trade)

Market	1980	1986	1992	1998	2000
<i>AC</i>					
Intra-regional	29.5	47.5	45.5	56.0	46.5
Extra-regional	3.6	6.9	11.3	12.8	10.1
<i>CACM</i>					
Intra-regional	74.3	72.5	63.7	59.2	54.7
Extra-regional	5.7	10.7	17.1	36.5	38.9
<i>Mercosur</i>					
Intra-regional	40.7	33.7	49.3	55.8	55.7
Extra-regional	28.1	35.4	38.2	35.1	39.7
<i>Mexico (NAFTA)</i>					
Intra-regional	9.2	52.8	74.7	85.1	84.5
Extra-regional	16.7	24.2	43.9	67.2	61.4
<i>Latin America¹</i>					
Intra-regional	46.3	50.7	57.9	60.8	55.9
Extra-regional	10.5	26.2	38.9	54.0	56.1

Note: Figures are simple averages.

¹ Includes Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Ecuador, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Panama, Paraguay, Peru, Uruguay and Venezuela.

it has also helped to further lower average levels of protection and improve competitiveness. Moreover, regional openness as a policy tool benefits from some nontraditional political economy considerations: the compensatory dimension of reciprocity, the ability to lock-in the reform through legally binding rule-based commitments, and the possibility of signaling liberalization commitments to the private sector, especially when it is not feasible to pursue further unilateral or multilateral openness (Fernández, 1997). Meanwhile, regional trade agreements, especially those with deep objectives—including second-generation free trade areas that go beyond traditional market access in goods—encourage the structural modernization of institutions directly through the disciplines they introduce, and indirectly through the increased demands brought about through regional competition.

- *Economic transformation.* While liberalization and increased participation in the world economy are viewed as instrumental to modernizing the region, countries have serious vulnerabilities because of a narrow export base and insufficient competitiveness of much of the private sector's export supply. The reciprocal openness, guarantees of market access, prefer-

ences and other aspects of a regional scheme can provide new opportunities for export experience and diversification and thereby over time serve as a strategic stepping stone to compete more effectively in a global economy. As can be seen in Table 2.4, inter-regional trade has a considerably greater presence of higher value-added manufactures than does extra-regional trade, which is more heavily laden with commodities. Moreover, this participation has tended to increase in the context of principal trade agreements. Regional markets also serve as an outlet for an important array of products in which Latin America has a comparative advantage—such as textiles, dairy goods, meat, and food processing—but faces persistently high levels of international protection.

Thus, while the new regionalism should aim to create trade, its underlying primary objective is to build on longer term strategic considerations arising from the need to overcome imperfect and incomplete markets at home and abroad that put developing countries at a serious disadvantage in the world marketplace. In effect, dynamic transformation effects are sought through the support of preferential access to a secure, enlarged market and the more specific information

Box 2.3 Why Intra-Regional Intra-Industry Trade Matters

Intra-industry trade is two-way trade in similar products. It is a widely observed phenomenon apparently at odds with the standard traditional theoretical models that explain international trade with differences in factor endowments. Building on the pioneering work of Lancaster (1979) and Krugman (1981) a “new” strand of theoretical trade literature provides a rationale for this phenomenon based on the role of economies of scale and product differentiation. The seminal index proposed by Grubel and Lloyd (1975), when computed at a sufficiently disaggregated level, can be used to illustrate the transformation of trade patterns. Table 1 presents the evolution of the Grubel and Lloyd index of intra-industry

trade observed in intra- and extra-regional trade flows of Latin American countries or subregions.¹

The index shows the dramatic impact of regional integration in the promotion of intra-industry trade. In fact, with the exception of the Dominican Republic, whose intra-industry trade relations with the United States are particularly intense even in the absence of a regional trading agreement, the index was higher in intra- than in extra-regional trade in 1997 in all countries and subregions. Through NAFTA, Mexico achieved the highest measure of regional intra-industry trade. Its levels today are comparable to those of developed economies. Mercosur and the Andean Communi-

Table 1 Grubel and Lloyd Index, 1980-97

Market	1980	1985	1990	1995	1997
<i>AC</i>					
Intra-regional	7.2	7.0	11.3	28.7	30.2
Extra-regional	2.8	3.9	7.6	8.4	6.7
<i>CARICOM</i>					
Intra-regional	17.5	11.5	23.0	18.4	14.2
Extra-regional	9.4	16.7	15.4	8.3	6.0
<i>CACM</i>					
Intra-regional	31.0	36.7	25.7	33.9	33.3
Extra-regional	2.9	3.8	7.2	6.8	17.0
<i>Mercosur</i>					
Intra-regional	17.0	21.1	36.7	47.9	51.2
Extra-regional	10.7	15.7	18.8	15.5	15.1
<i>Mexico</i>					
Intra-regional	14.4	50.2	34.4	56.8	60.0
Extra-regional	6.4	8.8	14.6	16.5	15.3
<i>Chile</i>					
Intra-regional	4.4	6.3	6.3	12.2	15.7
Extra-regional	2.1	2.1	3.5	3.2	3.3
<i>Dominican Republic</i>					
Intra-regional	0.3	1.1	0.8	1.9	2.3
Extra-regional	2.0	17.3	37.3	37.5	38.5
<i>Panama</i>					
Intra-regional	4.2	8.6	4.7	5.0	5.5
Extra-regional	0.2	0.4	0.7	0.2	0.3

Source: IDB calculations based on Feenstra (2000).

ty also feature an important and increasing degree of two-way intra-regional trade. In these groups, the expansion of regional intra-industry trade clearly accelerated in the last decade parallel to the implementation of new regional integration commitments.

At the microeconomic level, the surge of regional intra-industry trade provides preliminary evidence of the qualitative structural transformation fostered by regional integration. In fact, as intra-industry trade typically arises in trade of differentiated industrial products, it is not only a sign of a progressive maturing of the product composition of trade, but also of an expanding matrix of quality and of an emerging functional fragmentation of productive processes among regional partners.

At the macroeconomic level, the development of regional intra-industry trade alters the structure of interdependence through trade and promotes an increasing correlation of macroeconomic cycles. In fact, when national economies of an integrated regional market specialize in intra-industry trade, demand and productivity shocks affect partners in the same way. This, in turn, augments the correlation of macroeconomic cycles and points to macroeconomic policy coordination as an optimal policy choice.

Another interesting feature is that intra-regional specialization along the lines of intra-industry trade assuages the political economy resistance to trade liberalization, since such trade entails smaller labor market adjustment costs than inter-industry trade. Moreover, the mobility of labor across firms and occupations might be greater within industries than between industries, rel-

ative wages might be more flexible within industries, and other factors of production might also be more mobile within industries. In this light, intra-industry trade could be one of the factors helping to explain why the new regionalism of the 1990s has been relatively better received than globalization by Latin American societies as a tool of economic and institutional transformation

It is too early to precisely track the determinants of the intra-industry trade pattern of Latin American economies. Nevertheless, in the coming years, regional policymakers will probably want to nurture the development of intra-industry trade through the implementation of WTO-consistent sectoral policies.

¹ For each country, the trade-weighted intra-industry trade index is calculated for each single partner *i* and sector *j* according to the following formula:

$$IIT = \sum_{i=1}^m \left(\frac{X_i + M_i}{\sum X_i + \sum M_{i=1}} \right) \left(\sum_i^n \left(\frac{X_j + M_j}{\sum X_j + \sum M_j} \right) \left(1 - \frac{|X_j - M_j|}{X_j + M_j} \right) \right)$$

where X_{ij} and M_{ij} , respectively, represent exports to and imports from country *i* in product *j*. Calculations were performed using data aggregated at the four-digit level of the SITC (Rev. 2). Regional figures are weighted averages of the national indexes, using the relative share of each country in the total intra- and extra-regional trade of the selected region as weight. Intra-regional trade refers to trade occurring with regional partners; extra-regional trade refers to trade with the rest of the world.

flows, defined market competition and identifiable export opportunities that come from an institutionally organized regional platform. Over time, these advantages vis-à-vis the rest of the world are expected to serve as a catalyst for export diversification, investment, greater specialization via economies of scale and product differentiation, and inter-industry trade (see Box 2.3), all of which increase productivity, competitiveness, employment and growth. In the process, regional integration can also contribute to improving home markets in such areas as labor, finance and technology (Devlin and French-Davis, 1999).⁵

- *Attracting foreign direct investment.* There is

worldwide competition between developing countries to attract FDI because of its potential to improve export networks, technological and know-how spillovers, and institutional modernization. By creating a larger liberalized rules-based market with locational advantages, a regional agreement can distinguish member countries and help them compete for and attract FDI (Blöm-

⁵ There is some evidence that regional agreements such as NAFTA are associated with productivity gains. Meanwhile, some sectoral case studies supported by IDB/INTAL (1999) show mixed results regarding the productive transformation effects of regional integration, and are suggestive of both how those effects take place and how flawed policies can undermine them.

Box 2.4 An Emerging Opportunity for the FTAA: Hemispheric Petroleum Cooperation and Trade

The hemispheric energy imbalance presents a significant opportunity to deepen trade relations and continental integration all along the energy vector. This means not only the trade of primary energy, but also the trade of capital, technology, goods and services to produce energy-intensive goods from Latin America's large endowment of energy sources.

On the one hand, the United States has a growing energy deficit, currently importing 60 percent of the petroleum it consumes: 11 million barrels daily (MBD) with a consumption level of 19 MBD. The energy gap has tripled over the past 15 years, from 3.5 MBD in 1985 to nearly 11 MBD in 2001, as consumption levels have gone up with increased economic activity, and production levels have fallen as North American reserves have been depleted. If the trends of the past 15 years continue, U.S. imports could grow by approximately 9 MBD, or nearly double, over the next twenty years.

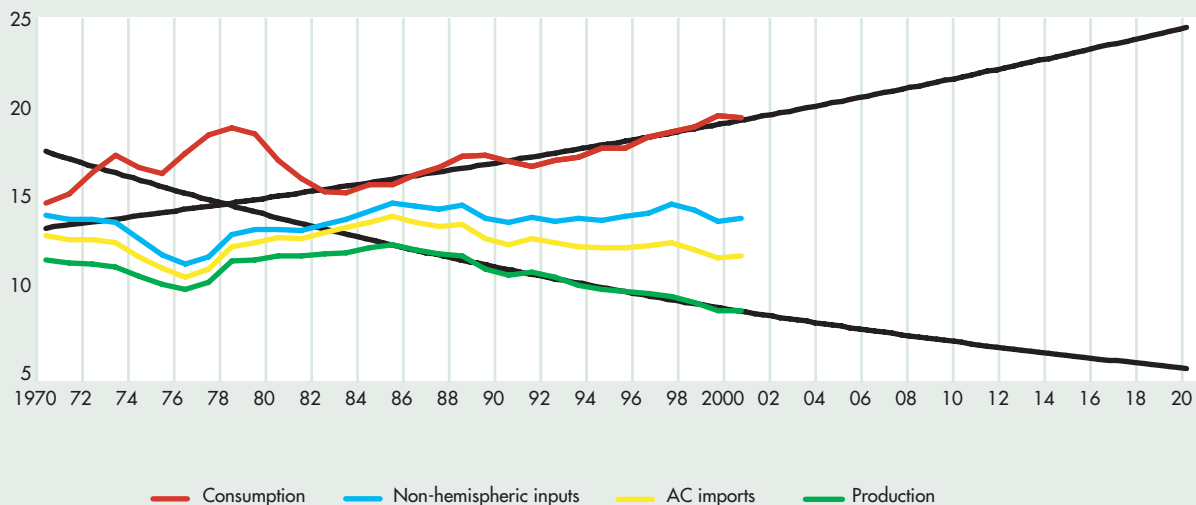
Both the magnitude and composition of imports have considerably changed in the past 15 years. At present, 50 percent of U.S. petroleum imports come from sources outside the hemisphere, while 30 percent are from NAFTA trading partners (Mexico and

Canada), and 20 percent from the Andean Community, particularly Venezuela. In the late 1980s, extra-hemispheric sources provided less than 30 percent of U.S. oil imports. Imports from outside the continent have quintupled in 15 years. This growing dependency presents concerns for the United States in terms of the security of supply. If net exports from the rest of the hemisphere to the United States do not increase in the future and the growth tendencies of U.S. imports continue, the country could reach an oil import dependence of up to 75 percent on extra-hemispheric sources, entailing greater security risks in terms of supply (see Figure 1).

The Latin American countries, on the other hand, are net exporters of energy and have the reserves needed to cover the United States' current and future hydrocarbon import needs. Over the past 15 years, Latin American net petroleum exports have doubled from 2 MBD to 4 MBD. If production and consumption trends remain the same, Latin America's net exports could grow by 2 MBD or 50 percent over the next twenty years.

However, even if we assume that all net exports from Latin American countries will go to the Unit-

Figure 1 Production, Consumption and Imports of Petroleum
(In millions of barrels per day)



ed States, their share of total U.S. oil imports would still drop from the current level of 32 percent to 27 percent by 2020. If, on the other hand, Latin American countries want their exports to rise to 50 percent of U.S. imports by 2020, exports to the United States would need to grow by 6 MBD instead of 2 MBD. This would mean practically doubling current production over the next 20 years.

There appear to be two possible scenarios for Latin American petroleum production. In the first, which we call “tendential,” production and consumption levels follow the same trajectory as during the past 15 years. Consumption grows by 4 MBD, production by 6 MBD, and thus exports by 2 MBD. In the second scenario of accelerated growth, production increases by 10 MBD, and as a result, exports grow by 6 MBD.

Both scenarios would require respective investments of either \$120 billion or \$200 billion just to increase production. And if the costs of maintaining the increase in production were added to these investments, total expenditures in the petroleum sector for both scenarios would hit between \$143 billion and \$233 billion, respectively. Finally, both directly and indirectly, the impact on the regional GDP is estimated at between \$200 billion and \$320 billion. These numbers represent 10 percent and 17 percent of the current aggregate value of the Latin American economies in one year. This impact would be significant—greater than the impact of any other individual industrial activity in the region.

strom and Kokko, 1997). Moreover, FDI tends to cluster, so initial success can lead to more success (Ethier, 1998). However, the strategic response of FDI to regional agreements is very complex. The 1990s coincided with a boom in flows of FDI to Latin America. There is evidence that some of this was the result of development of regional agreements such as NAFTA, but in general other domestic market-based factors appear to have been more important (Amann and Vodusek, 2001; IDB/INTAL, 1999).

- *Geopolitics.* A group of like-minded countries can use a regional agreement to establish a safety net for fragile democracies, promote disarmament and peace among neighbors, and enhance bargaining power in international fora. These motives were in part behind the decisions of Mercosur, the Andean Community and CARICOM to negotiate trade agreements in blocs. The partners of Mercosur and the Andean Community have collaborated to overcome threats to democracy in member countries and to help resolve border conflicts (Devlin and Estevadeordal, 2001).

- *Functional regional cooperation.* For several reasons, reciprocal preferential trade agreements are a common point of departure or core strategic compo-

nent in the launch of formal regional integration initiatives (Devlin, Estevadeordal and Krivonos, 2002). First, trade usually attracts support from the relatively well-organized and financed private business communities. Second, unlike many other economic arrangements, the mutual benefits of trade agreements and their distribution can be reasonably assessed *ex ante* by participants and monitored and enforced *ex post*, as they usually contain very precise legal clauses. In addition, the institutions for negotiating cross-border agreements and administering them are already in place through trade-related ministries and established negotiating fora and practice. Third, trade agreements accommodate nationalist sentiments, as they can be designed in ways that initially involve little concession of national sovereignty, as do free trade areas. Fourth, these trade agreements are subject to certain multilateral rules and procedures in the WTO. Finally, a critical mass of regional trade among partners acts as a “hanger” on which other areas of regional cooperation can be draped. (Box 2.4).

Indeed, growing and mutually beneficial economic interdependence among partners typically induces demands for additional regional economic

Table 2.5 | Regional Cooperation Programs in APEC**Trade-related cooperation**

Deregulation, dispute mediation, implementation of WTO obligations, customs procedures, standards and conformance, intellectual property rights, competition policy, government procurement and rules of origin

Non-trade cooperation*Economic*

Macroeconomic policy, financial stability, structural reforms, economic infrastructure, business facilitation, financial systems, free movement of investments, mobility of businesspeople, capital markets, energy, tourism, fisheries, transportation, telecommunications, small- and medium-sized enterprises, agriculture, rural infrastructure, food production and biotechnology

Political

Political dialogue through ministerial meetings

Social and cultural

Public safety, social development and gender integration

Environment

Environmental protection and marine resource conservation

Human resources, science and technology

Industrial science and technology, human resources development, knowledge and skills development, information and communications technology, and electronic commerce

Other

Emergency preparedness

Source: Devlin, Estevadeordal and Krivosos (2002).

cooperation to exploit more fully the advantages of a maturing regional market. Moreover, demands for noneconomic and even political cooperation arise from the social externalities generated by closer economic ties. Thus, the centripetal forces of trade among partners can be an effective handmaiden of deeper formal integration, whether planned or not. There is the contemporary example of Western Europe, where growing interdependence through trade has served to drive forward a political agenda of certain partners for deep integration and broad-based cooperation. In effect, the opening of the regional market in Europe became functional to widening the scope of cooperation, or in the words of Garcia Herrero and Glöckler (2000), to "integration by stealth."

Regional cooperation between two or more countries also can take place without pretensions of regional integration as such (Balassa, 1961). This more "functional" regional cooperation involves an adjustment of policies and activities between countries to achieve outcomes that the parties prefer to the status quo, and is possible in practically any field of public policy. While functional regional cooperation can and

does emerge independently of formal integration, it also can constitute a parallel track to such a formal process, or over time contribute to the emergence of that process.

As the regionalization of trade has progressed in the 1990s, there has been growing interest in functional regional cooperation among members of different integration agreements in economic, social and political areas that address externalities arising from increasing interdependencies or dependencies in regional, hemispheric and interregional markets. Development of regional infrastructure has become a focal point of functional cooperation in Latin America, as reflected in the South American Initiatives for Regional Infrastructure Integration (IIRSA), which involve 12 countries, and the Puebla-Panama Plan (PPP), which involves eight countries. Support for business, control of natural disasters, environmental protection and regional security are some of the other principal emerging areas of regional cooperation in Latin America.

There are also several ambitious cooperation initiatives that accompany North-South free trade ini-

Table 2.6 Santiago Summit - Areas of Action

- *Education*

- *Preserving and strengthening democracy, justice and human rights*
 - Democracy and human rights
 - Education for democracy
 - Civil society
 - Migrant workers
 - Strengthening municipal and regional administration
 - Corruption
 - Financing electoral campaigns
 - Prevention and control of illicit consumption of and trade in drugs and psychotropic substances and other related crimes
 - Terrorism
 - Building confidence and security among states
 - Strengthening of justice systems and judiciaries
 - Modernizing the state in labor matters

- *Free Trade in the Americas*
 - Free Trade Area of the Americas (FTAA)
 - Strengthening, modernizing and integrating financial markets
 - Science and technology
 - Regional energy cooperation
 - Hemispheric infrastructure
 - General infrastructure
 - Transportation
 - Telecommunications

- *Eradication of Poverty and Discrimination*
 - Fostering the development of micro and SMEs
 - Property registration
 - Health technologies
 - Women
 - Basic rights of workers
 - Indigenous populations
 - Hunger and malnutrition
 - Sustainable development
 - Cooperation

Source: Summit Declarations and Plans of Action.

Table 2.7 Typical Areas of Cooperation in EU-Latin America Inter-regional Integration Agreements

- *Political dialogue*
 - Peace and stability
 - Confidence and security building measures
 - Protection of human rights, democracy and rule of law
 - Sustainable development
 - Action on drug traffic, arms traffic, organized crime and terrorism

- *Economic cooperation*
 - Industrial cooperation
 - Technical regulations and conformity assessment
 - Services
 - Investment promotion
 - Macroeconomic policy
 - Scientific and technological cooperation
 - Energy cooperation
 - Transport
 - Telecommunications
 - Agriculture
 - Fisheries
 - Customs procedures
 - Statistics
 - Environment
 - Consumer protection
 - Data protection

- *Financial and technical cooperation*
 - Public administration modernization
 - Inter-institutional cooperation
 - Cooperation on regional integration

- *Social and cultural cooperation*
 - Social cooperation
 - Education and training
 - Social dialogue
 - Drugs and organized crime
 - Culture

Source: Devlin (2001).

tiatives. (See Tables 2.5 through 2.7) The 34 democracies of the Western Hemisphere in 1994 launched a number of cooperative initiatives along with the eventual creation of a Free Trade Area of the Americas (FTAA). Meanwhile, the free trade initiatives of the EU are also accompanied by a battery of economic cooperation and political dialogue programs. Extensive cooperative programs are integral to the APEC free trade process as well.

Functional cooperation is inherently challenging. The difficulty of negotiating non-trade issues is related to their very nature: whereas preferential trade arrangements, the typical starting point for formal eco-

nomics integration, are concerned with removing distorting policies, cooperation in other economic areas as well as in social and political fields often requires *introducing* additional policies, which can be more difficult. Moreover, non-trade areas often have less installed institutional cross-border capacities than does trade, and hence need more intensive mobilization of collective financial, logistical and technical support. Finally, many areas of functional cooperation are not easily subject to quantifiable targets, effective monitoring and evaluation of results. These complexities become especially daunting when functional cooperation is inter-regional and involves a large number of

heterogeneous countries, as in the case of the hemispheric summit process (Devlin, Estevadeordal and Krivonos, 2002).

Potential Costs of the New Regionalism

Regional integration agreements are an integral part of the structural reform process, but like any other structural change, they require adjustments and bear potential costs for the participating countries. Countries should design agreements that minimize unnecessary costs where possible. Some of the typical costs for countries associated with regional integration agreements are:

- *Trade diversion.* Preferences in regional trade agreements (coupled with rules of origin in free trade areas) can potentially divert trade away from more efficient locations in non-member countries. Some trade diversion is inevitable in preferential arrangements, which has costs for domestic consumers and non-members. This must be weighed against trade creation and the potential for the trade diversion to evolve into cost-reducing and welfare-enhancing transformation effects that promote future growth and import capacity (Corden, 1972; French-Davis, 1980).

The trade creation vs. trade diversion debate goes back to the days of Jacob Viner (1950) (Box 2.5). He pointed out the risks of trade diversion during the era of the old regionalism, when protection against third parties was very high and even rising (Devlin and Estevadeordal, 2001). That risk again has emerged as a source of concern in the contemporary debate over the new regionalism (Bhagwati and Panagariya, 1996). However, recent empirical evidence points largely to the trade creating effects of the three-tier liberalization process, of which regional integration is a part.

- *Vulnerability of regional goods.* A regional agreement can create trade but at the same time support the circulation of goods in the regional market for which there is little demand in the rest of the world. The lack of an external market may be due to the idiosyncratic nature of certain goods based on local culture and tastes, to rigid intra-firm export and marketing networks, or to a lack of international competitiveness of the goods (due, for example, to low productivity or an

overvalued exchange rate), which is accommodated by preferences and rules of origin.

If regional trade is created or diverted much faster than the dynamic forces leading to international competitiveness, growing trade and interdependence with a partner country may lead to a member or members becoming excessively vulnerable to recession or exchange rate depreciation in the regional market. This is because in the face of a recessive regional market or depreciation by a major partner, exports cannot be easily redirected to alternative third markets. As noted by Bevilaqua and Talvi (1999), this problem has occurred in Mercosur, where Argentina, Paraguay and Uruguay are very dependent on the regional market for their exports. It may also be a factor in some sectors in Mexico, where through NAFTA there is a high level of integration with the production and marketing networks of the U.S. economy (Dussel Peters, Paliza and Loria Diaz, 2002).

This type of vulnerability can occur in any integration arrangement where regional trade expands rapidly under an umbrella of external protection for industrial sectors that is significantly higher than the rest of the world, where rules of origin are restrictive, or where simultaneous exchange rate appreciation among partners could drive sales to the regional market (Devlin and French-Davis, 1999). Such vulnerability points to the need to progressively reduce external protection and the restrictiveness of rules of origin as commercial interdependence deepens among partners of a regional agreement, and to guard against premature or abrupt currency appreciation with the rest of the world.

- *Redistributive effects from lost tariff revenue.* When there are serious asymmetries in the average external tariff levels between partners of an economic integration agreement, the loss of tariff revenue in the high tariff country can have a serious redistributive impact on the partners (Panagariya, 1996). In effect, part of what would have been realized as tariff revenue on imports by the high tariff country from the lower tariff partner prior to the agreement is transferred to the lower tariff country's producers as tariffs are eliminated in the regional agreement. This is because the low tariff country's exporters refer to the partner's significantly higher third party tariff when establishing their pricing. The problem is aggravated by trade diversion.

Box 2.5 Trade Creation versus Trade Diversion

Although regional integration agreements are seldom implemented exclusively on the basis of economic rationales (Fernández and Portes, 1998), their welfare effects have been the main focus of an extensive and growing body of literature surveyed both for academic and policy-oriented purposes.¹ The analysis is very complex, as preferential trade liberalization engenders second-best equilibria for which analysts need comprehensive analytical frameworks and sophisticated empirical techniques.

The early seminal contribution of Viner (1950) to the theory of customs unions set the stage for the debate highlighting the static *trade creation and trade diversion* effects of regional integration agreements on single industries. As a result of preferential trade liberalization, trade creation is the substitution of a lower-cost source of supply from a member country for a higher-cost domestic source of supply, while trade diversion is the substitution of a higher-cost source of supply from a member country for a lower-cost source of supply from a third country. Under certain conditions, regional integration agreements can result in welfare-enhancing outcomes for member and nonmember countries (Kemp and Wan, 1976), while trade creation and diversion effects may materialize even prior to entry into force of the agreement, as traders and investors anticipate signing of an accord (Freund and McLaren, 1999). The assessment of the net effect therefore needs a careful analysis of the market structure and costs in which integration policy intervenes, a full account of its dynamic effects in the longer run, and an explicit account of the institutional forms of regional integration agreements (Pomfret, 1997).

Applied research also provides a progressively better understanding of the magnitude of the effects of regional integration. In particular, in the case of Latin America, the new regionalism of the 1990s stimulated an emerging empirical literature that has progressively mitigated early concerns about the harmful effects of regional integration on the welfare of members and nonmembers. A complete survey of the empirical literature on the region would extend beyond the scope of this study, but a few of the significant contributions focusing on the trade creation/diversion impact of the region's major agreements are reviewed below.

Early comprehensive assessments of NAFTA such as Hufbauer and Schott (1993) converge around the conclusion that the extraordinary expansion of intra-regional trade flows did not take place at the expense of the rest of the world. Analyzing the geographical evolution and the composition of trade flows at the sectoral level, Krueger (1999) notes that the implementation of preferential trade policy has been more trade-creating than trade-diverting, given the already high intra-region-

al share among the members of the agreement and the parallel increase of trade flows with the rest of the world. Krueger also stresses the role of the evolution of the real exchange rate in explaining the expansion of intra-regional trade flows. The analysis found that the entry into force of the regional integration agreement did not significantly alter the trade pattern, a conclusion also suggested by Soloaga and Winters (1999).

Mercosur has received less empirical attention, but it nevertheless has generated a very lively debate. In an early study, Yeats (1997) concluded that the regional orientation of exports grew faster in products where member countries do not have comparative advantages, and accordingly concluded that there was significant trade diversion. This conclusion has been challenged by Nogues (1996), who stressed the actual existence of intra-regional comparative advantages among Mercosur members in certain sectors. Meanwhile, Devlin (1997) noted that an analysis of the trade pattern distortions should be focused on imports, which suggests that the regional bias has been mitigated by the unilateral liberalization that paralleled implementation of the agreement. Nagarajan (1998) comes up with a similar empirical conclusion, hence pointing to the fact that trade creation probably outweighed trade diversion. In addition, Giordano (2001) shows that the reorientation of regional trade flows crucially hinged on the divergent path of the intra- and extra-regional real effective exchange rates. These conclusions are supported by Soloaga and Winters (1999), who, using a gravity model, assert that the significant trend in members' trade presumably reflects unilateral trade liberalization and suggests that trade performance was dominated by currency overvaluation rather than trade policy as such. Meanwhile, Echavarría (1998), examining intra-regional trade flows in the Andean Community, points to the trade-creating effects of the agreement.

Finally, computable general equilibrium studies of regional integration that incorporate the findings of the new growth theory have invariably found that trade creation greatly dominates trade diversion (Robinson and Thierfelder, 1999). In the case of NAFTA, this is confirmed by Francois and Shiells (1994) who conclude that all members stand to gain, particularly Mexico, which could increase welfare between 1 and 5 percent. In the same vein, analyzing Mercosur, Flôres (1997) showed that Argentina, Brazil and Uruguay might increase GDP by 1.8 percent, 1.1 percent and 2.3 percent, respectively.

¹ For academic purposes, see Baldwin and Venables (1995), Winters (1996) and Panagariya (2000). For policy-oriented purposes, see OECD (1995), WTO (1995) and World Bank (2000).

Panagariya (1996) indicates that this effect was significant for Mexico when it joined NAFTA, since the United States and Canada had much lower third party tariffs. It was clearly a price Mexico was willing to pay as part of the trade-off in pursuing the benefits of economically integrating with North America. To offset this cost, Mexico has been lowering average levels of protection by signing free trade agreements with most Latin American countries and the European Union, while pursuing such an agreement with Japan.

- *Asymmetric development impact.* In the absence of corrective mechanisms, the development benefits of regional integration are often asymmetricaly distributed among partner countries or regions within them (Puga and Venables, 1997). European integration has been very sensitive to this problem, reflected in the creation of a comprehensive battery of collective institutional mechanisms to address potential imbalances (Pastor, 2001).

Severe imbalances in trade and adjustments historically have been a major source of tension for Latin American regional initiatives and in some cases have even led to their demise (Salgado, 1979). In the old regionalism, there were extensive provisions for special and differential treatment for less developed countries to address some of these problems. However, the new regionalism has tended to give much less attention to special treatment, typically restricting it to somewhat longer liberalization schedules for the lesser developed partner (Devlin and Estevadeordal, 2001).

Asymmetric liberalization may facilitate the phase-in of regional liberalization, but there are many other sources of imbalances and tension among partners when regional trade reaches significant proportions. As economies become more interdependent in the course of developing regional agreements, lack of coordination of macroeconomic policy and exchange rate regimes can be an especially corrosive factor in regional commitments. Indeed, parallel to Latin America's successful phase-in of regional free trade has been a growing and largely unaddressed need to better coordinate macro and exchange rate policies among partners.

Regional integration also can have clear asymmetric effects within a partner country. This has occurred in Mexico, where the pull of NAFTA has been

heavily concentrated in the northern states, aggravating a North-South development divide in that country (Perry, 2001). The Puebla-Panama Plan launched in 2001 was inspired in part by the Mexican government's desire to provide compensatory forces of development for its southern states.

- *Spaghetti bowl.* A growing number of economic integration agreements with different liberalization schedules, preferences, rules of origin and other norms and disciplines creates a virtual "spaghetti bowl" of regulatory systems for trade. This reduces transparency and raises administrative costs (Wonnacott and Wonnacott, 1995). As will be seen in Chapter 3, the "spaghetti bowl" in the Americas is large and growing. An additional inefficiency is when hub-and-spoke arrangements emerge in which a hub country has free trade agreements with a number of partners that do not have similar agreements with each other. This encourages trade and investment diversion (Wonnacott, 1996). With their multiple agreements, Mexico and Chile have become trade hubs in the Americas. The United States could become a major trade hub as well if it continues to pursue bilateral reciprocal agreements.

- *Investment diversion.* While enlarged regional markets and preferences can attract foreign direct investment, they potentially could divert FDI from more efficient locations (Winters, 1998). In the Vinerian perspective, the location of FDI can be motivated by trade diversion arising from high tariffs and non-tariff barriers (including rules of origin) in order to capture the discriminatory static effects of regional integration (Kindleberger, 1966). Even efficient location of FDI can have perceived costs for certain countries. For example, tariff-jumping FDI may relocate to a more efficient location in a partner country when regional trade and investment is liberalized.

- *Other costs.* It has been argued that integration agreements can create a "gang effect" that leaves outside countries with little option but to join for fear of trade and investment diversion (Winters, 2000). This clearly is a dynamic that countries face in the wave of the new regionalism. Uruguay and Paraguay probably could not have easily stood by as passive observers to integration between Brazil and Argentina. Mexico's joining of NAFTA contributed to the demand in Central America for free trade agreements with the

United States and Canada. Of course, the coercive effects of regional integration should be evaluated in terms of the contribution the agreements give to structural reform versus alternative paths to achieving this, and in this context the pressure for joining an initiative could be a benefit and not a cost.

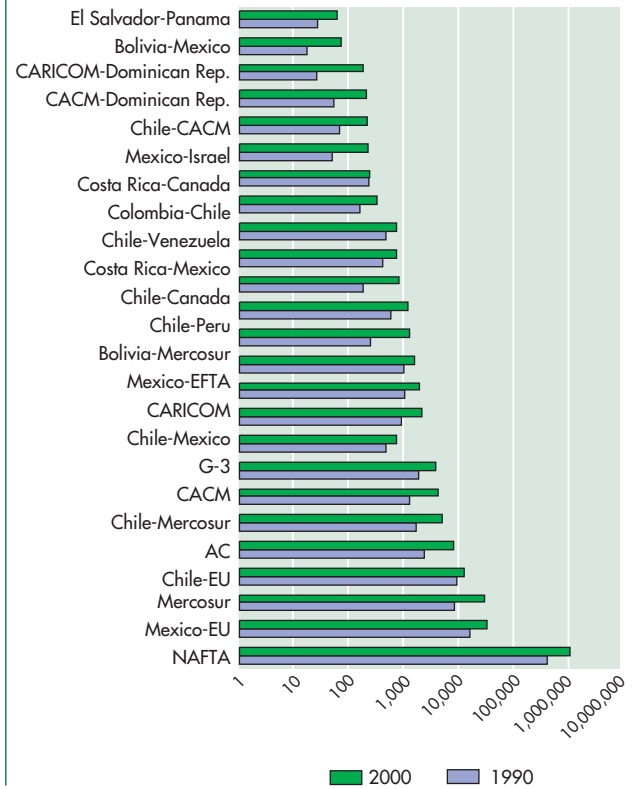
Meanwhile, the formation of large regional blocs can create market power and shift the terms of trade with the rest of the world, a benefit for the region but a cost for others (Stein, 1994; Winters, 1998). In a world of perfect competition, this would represent a welfare loss; however, in the real world in which countries operate, one could not conclude that a priori. In any event, Schiff and Chang (2000) have estimated these effects in the case of the formation of Mercosur.

Evaluating the Balance of Benefits and Costs

Finally, it must be remembered that regional integration is not an end in itself but an instrument to achieve an objective. Hence, not all regional integration initiatives make economic sense, and even those that do can go awry if the policy framework is inadequate. Hence, evaluating the benefits of initiatives, and weighing those benefits against the costs, is the only way to determine whether an agreement makes sense for the participating countries and the rest of the world. One key question regarding an agreement is its economic relevancy. There has been a proliferation of nearly 30 integration initiatives already in the region and several more are being negotiated. But have they generated trade? Figure 2.6 shows that most of the agreements are associated with a significant amount of increased trade.⁶ The possibility of new markets for trade is only one consideration of the economic value of new agreements. A much more thorough empirical analysis of effects is required. Unfortunately, empirical evaluation is inherently difficult due to extremely serious gaps in data availability, the complex causality of dynamic productive transformation effects (where one expects the big effects to lie), and the methodological difficulties in generating plausible conclusions from broad counterfactual analysis (Devlin and French-Davis, 1999).

Since the new regionalism is about much more than trade as such, the attention of analysts must go beyond the “static” trade creation-diversion examination (which has had its empirical problems as well; see

Figure 2.6 Intra-regional Trade, 1990-2000
(In millions of constant 1990 dollars)



Source: IDB calculations based on IMF (2001).

Winters, 2000) to focus more on the difficult-to-evaluate world of dynamic sectoral and economic productivity and growth effects (or lack of them), and on the contribution of regionalism to the political economy of structural reform. Moreover, political objectives also must be assessed, since these weigh heavily in many initiatives, particularly in agreements aimed at a common market or community. This type of comprehensive evaluation has largely escaped the debate to date.

North-South Agreements and the FTAAs

The growing interest in Latin America for regional agreements with industrialized countries is in some ways the best expression of the new regionalism. Such agreements link countries in the process of structural

⁶ Of course, more analysis is needed to determine the causality between the agreement and trade.

reform with countries that have already achieved a high degree of liberalization. Hence the burden of liberalization in the regional agreement weighs asymmetrically on the reforming country. Moreover, the agreements tend to have a comprehensive second-generation scope of disciplines, so the implications for structural change are large for the developing country partner.

Why do countries subject themselves to an asymmetrical liberalization process? Basically because many expect that when a regional agreement is anchored by a credible industrialized country, the benefits for structural reform outlined earlier will be magnified at an acceptable cost.

One of the primary goals of the developing country partner is market access. Even though the industrialized partners typically have low average most favored nation (MFN) tariffs and extensive non-reciprocal preferences for the region, there are tariff peaks, quotas and other non-tariff barriers and distortions that inhibit trade in many goods for which Latin America has a clear international comparative advantage. Agricultural products are a notorious example of this problem. Moreover, some analysts have pointed out that North-South agreements are less prone to trade diversion than South-South agreements because of the more general standard of international competitiveness in the industrialized area and the already relatively high participation of trade with these markets (Venables, 2001).⁷ In any event, simulations of a Computable General Equilibrium model suggest that North-South market access agreements such as the FTAA, or those with the EU, would have significant impacts on export and GDP growth, assuming that trade barriers in the partner countries are eliminated comprehensively and include agriculture (see Appendix 2.1).

Perhaps even more important for the developing country partner is the desire to stabilize market access through a comprehensive set of rules and dispute settlement mechanisms with the industrialized partner. This is because market access can be interrupted by unilateral measures such as anti-dumping action, safeguards, withdrawal of non-reciprocal preferences, and tariff increases within WTO bound rates. Regional agreements are an opportunity to reciprocally confine the use of these types of threats to market access. Another major motivation is to anchor

economies by a regional agreement with a credible industrialized country; this would be expected to significantly lower the country's risk premium and attract investment flows (Ethier, 1998; Fernández-Arias and Spiegel, 1998). Finally, lock-in effects for reforms of subregional agreements have a checkered history. While they have been better in the era of new regionalism, they still are far from perfect (Devlin and Estevadeordal, 2001). In contrast, lock-in is expected to be stronger in North-South agreements, since industrialized countries tend to have considerable economic power and a battery of national institutional arrangements that vigorously enforce and monitor compliance of agreed rights and obligations (Devlin, Estevadeordal and Garay, 2000).

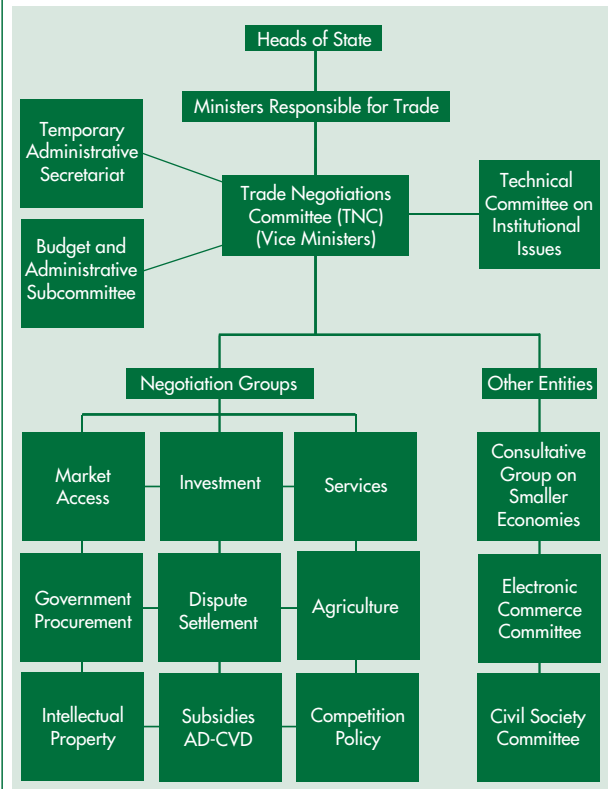
Meanwhile, the motivation of industrialized areas for integration agreements includes eliminating tariff barriers, since average tariffs in the region are three to five times higher than those in the Northern markets. But the major focus is on promoting commitments beyond WTO levels (and setting precedents to expand this frontier even further) on new trade-related areas such as services, investment, intellectual property, and government procurement. Another objective is to promote national policy agendas that are not widely agreed upon in multilateral fora, such as trade and labor standards, transparency, and issues related to consultation with civil society.⁸ Another important goal is geopolitical market positioning in an age of globalization.

The North-South agreements are challenging indeed for the region. The implications for opening markets are substantial in view of the relatively higher levels of protection in the region. Also, Latin America has not yet advanced substantially in many of the new trade issues. For example, liberalization of financial services often has not moved much beyond protocols

⁷ However, this is not true for all of the important sectors (e.g., textiles), and hence serious trade diversion can be a risk (Panagariya, 1996).

⁸ This dynamic can be seen in the behavior of the United States and the European Union. U.S. interest in a free trade area with Canada and its extension to NAFTA (breaching that country's singular traditional focus on multilateralism) was spurred by creation of a single market in Europe and an effort to use the NAFTA agenda to drive home U.S. negotiating objectives in a lagging Uruguay Round. Meanwhile, the EU's recent interest in pursuing reciprocal free trade with Latin America is probably partially related to advances in the FTAA (IDB, 2002).

Figure 2.7 Structure of the FTAA Negotiations



or statements of intentions. Moreover, there is an asymmetric capacity between the industrialized country and the region to negotiate sustainable agreements and implement them. And, of course, many adjustments will be needed to make up for lost fiscal revenue from tariff elimination, ensuring stable financial systems and macroeconomic environments in the face of capital inflows set off by the agreements, and establishing a policy framework that addresses the impact of trade on poverty and equity. A challenging agenda, but one that many Latin American countries are willing to take on in order to capture the potential trade and political economy benefits from fortifying links with their major markets.

The FTAA is clearly the region’s biggest North-South initiative, involving all democratic Latin American countries and North America. It would be the world’s largest free trade area: 34 countries with 800 million people and a \$10 trillion regional economy. It promises not only to liberalize trade with North Amer-

ica but also between the subregions that do relatively little trade with each other.⁹ The process was launched at the December 1994 Miami Summit, but only with great difficulty, as trade did not appear on the program until just a few months before the event due to some initial ambivalence in North America (Hayes, 1996). Pressure from Latin America was decisive in putting trade at the center of the summit agenda.¹⁰

The FTAA initiative bears all the characteristics of a modern second-generation trade agenda. A comprehensive preparatory process began in June 1995 and ended with the beginning of formal negotiations in September 1998 involving nine areas (Figure 2.7). The goal is a balanced and comprehensive WTO-consistent agreement by January 2005 that will be determined by consensus and be a single undertaking. The agreement must take into account the needs, economic conditions and opportunities of the smaller economies of the region, which confront special vulnerabilities (Box 2.6). The FTAA can coexist with bilateral and sub-regional agreements to the extent that the rights and obligations under these agreements are not covered or go beyond the rights and obligations of the FTAA (FTAA Declaration of San José, 1998). Hence a comprehensive FTAA could potentially absorb some of the hemisphere’s free trade areas or even subregional agreements if because of problems they do not advance beyond (or slip back into) de facto simple free trade zones.

The process has proceeded steadily since 1995 (Table 2.8), with disciplined organization and strong commitments on the part of governments in terms of participation, time and expense. For example, negotiations in 2000 involved 184 meeting days with more than 3,000 participants, generating more than 2,000 negotiating documents. A bracketed draft text of the negotiated FTAA agreement was publicly released in 2001. Meanwhile, in May 2002 the delegations agreed on the methods and modalities for product and sectoral specific liberalization, which sets the stage for the final round of negotiations involving offers and

⁹ For instance, less than 5 percent of Andean and Mercosur trade is between the two blocs (IDB, 2000).

¹⁰ The decision was by consensus of 34 countries.

Box 2.6 Challenges Facing Small Countries

The onset of globalization and the ongoing process of multilateral trade liberalization have sparked an international debate on the unique circumstances of small countries in the world economy, particularly their vulnerability to adverse external shocks and natural hazards. The debate has spurred proposals that small economies should enjoy longer transition periods to comply with commitments; fewer and less onerous international obligations; assistance with trade adjustment and risk management; and greater security and predictability in market access.

Such proposals stem from characteristics these countries share based on their smallness and remoteness. Relative to larger regional neighbors, they tend to have more specialized and less diversified economies, often with exports concentrated in few commodities. They have diseconomies of scale and investment; are unusually open to external economic developments in the areas of trade, capital flows and technology; are heavily dependent on foreign capital flows; and have high international transport costs. An extensive and growing economic literature highlights these common features and examines a number of common problems related to them.

Income Volatility

Small countries often have higher rates of growth than larger neighbors, but their growth rates fluctuate more widely. They tend to rely heavily on external trade in goods and services, and to be open to foreign investment, as means of overcoming the inherent scale limitations of small domestic markets and resource bases. Since the share of trade in such countries' GDP is often especially large, and since their exports are generally concentrated in both products and markets, they experience much greater variations in their terms of trade and their growth rates. Small states' standard deviation of annual real per capita growth might be some 25 percent higher than in large countries (Commonwealth Secretariat/World Bank Task Force on Small States, 2000). It has been argued that the disadvantages of volatility are offset by the advantages of trade openness (Easterly and Kraay, 1999). Greater market access, however, does not automatically entail greater market entry: the balance of benefits and risks depends on whether more openness in small countries is matched by more secure market penetration in their trading partners.

External Shocks and Access to Capital

Product concentration and export specialization in a small number of key commodities, part of an effort to achieve economies of scale in small countries, can boost productivity and competitiveness in global markets. The limited diversification, however, makes these countries vulnerable to shocks and market disruptions such as commodity price fluctuations, market access difficulties, natural disasters, and product blight, as well as to the strong bargaining power of multinational firms. The banana dispute between the United States and the European Union over the preferential treatment of Caribbean bananas in the European market illustrated the fragility of small states that are reliant on preferential arrangements, as well as their susceptibility to disruptions in market access. Limited diversification also heightens economic risk, which in turn affects the capacity of smaller economies to access international financial markets. Moreover, they are perceived as riskier than large countries. In effect, they are discriminated against: when the quality of their policies and human capital is comparable to that of bigger countries, they are still judged to be a greater investment risk, face higher risk premia, and typically pay higher interest rate spreads. Additionally, intense competition to attract investment prompts the need for ever greater (and fiscally pernicious) incentives and the commitment of increasing resources to investment promotion (Commonwealth Secretariat/World Bank Task Force on Small States, 2001).

Trade Liberalization and Revenue Loss

Many small states have benefited from preferential market access and relatively high levels of official development assistance from OECD countries. Members of the African, Caribbean and Pacific (ACP) group of states have enjoyed a special relationship with the EU in both of these areas. As preferential access to traditional markets is eroded by trade liberalization, small states face a dual problem. On the one hand, they must adapt to the loss of preferences in the markets of their main trading partners. On the other, they are obliged to lower or eliminate their own trade barriers. Since they have a small domestic tax base, however, many small countries have depended on tariff income as a substantial source of government revenue. Such earnings will necessarily decline as tariffs are reduced and must be replaced by sizeable adjustments of tax structures to bring in new sources of revenue.

Limited Institutional Capacity

Smaller economies have low staffing levels in their public administrations. Personnel tend to be overextended and responsible for multiple tasks, while specialists are often not retained. Limited financing contributes to high staff turnover and precludes frequent training, which in turn hinders the accumulation of management skills and constrains innovation (ECLAC, 2000). One outcome is a curbed capacity to engage effectively in the negotiations that underpin trade and integration initiatives.

Business Adjustments and Private Costs

Greater competition from import liberalization leads to the local concentration of small firms in sectors where they have a competitive advantage. The specialization and resource reallocation required for that purpose can have significant adjustment costs, the burden of which often falls on workers in firms and industries that face the immediate prospect of redundancies, and on poor households for which unemployment is highly problematic. The social benefits of reform can offset the social costs over the longer term, but the *private* costs of adjust-

ment are inequitably distributed, and resistance to them can thwart trade liberalization efforts (Gonzales, 2000). Additionally, the higher transport costs prompted by distance and limited trade volumes, as well as fragmented production bases, conspire to frustrate the greater productivity necessary for international competitiveness. This is especially the case in island and archipelago states, where the problem is not simply one of distance: in some cases there is a small number of transport providers holding a monopoly on service provision.

Natural Disasters

Many small countries, notably in Central America and the developing island states of the Caribbean, are unusually exposed to natural hazards. Caribbean countries in the hurricane belt annually face the prospect of devastation and share with other countries of the Americas a natural exposure to volcanic activity, earthquakes, mudslides and floods. Since the economies, land area and populations of these countries are small, natural disasters can adversely affect a large proportion of economic activity and export capacity.

requests for achieving defined liberalization schedules by December 2004.

As pointed out by Blanco and Zabludovsky (2002), while the negotiations have advanced steadily to date, this last stage will be critical and extremely difficult. Although the 34 countries of the FTAA represent a more compact negotiating vehicle for obtaining consensus than the 140-plus WTO membership, agreement among countries as heterogeneous in terms of levels of development (from some of the poorest to the richest in the world) and geopolitical perspectives as those in the FTAA will demand creative formulas that provide for both balance and substantial liberalization. Examining trade patterns, Blanco and Zabludovsky observe that the most aggressive targets of many countries' FTAA trade agendas are often the most politically sensitive defensive sectors of others, and vice-versa. Then there are complex technical issues such as what types of rules of origin are need-

ed to ensure full participation in FTAA trade opportunities, minimize trade and investment diversion, and provide for a manageable administrative burden. How to treat the smaller economies will be a delicate political issue. Bridging these and other tradeoffs will not only tax the technical skills of negotiators, but also require renewed political leadership to overcome the region's recent economic difficulties and increasing signs of protectionist pressures in the hemisphere.

Meanwhile, sustainable agreements require effective negotiation and implementation as well as policies to foster socially efficient adjustment. On all these accounts, the institutional capacity of many Latin American countries leaves much to be desired. Agreement on a cost efficient and effective FTAA institutional architecture also may prove difficult given fiscal restraints on all member countries and the diverse traditions in the hemisphere, ranging from purely inter-governmental arrangements to more comprehensive

Table 2.8 Chronology of the FTAA Process

Date	Event	Action
Pre-negotiation period		
December 1994	First Summit of the Americas (Miami)	Launches the FTAA process.
January 1995	OAS Special Committee on Trade	Establishes initial work plan and timetable.
June 1995	Denver Ministerial Meeting	Seven working groups established; IDB-OAS-ECLAC Tripartite Committee charged with providing technical support.
March 1996	Cartagena Ministerial Meeting	Four additional working groups established.
May 1997	Belo Horizonte Ministerial Meeting	Working groups mandated to complete all work by next Ministerial Meeting; one additional working group established.
March 1998	San José Ministerial Meeting	Launch of negotiations recommended; agreements reached on structure, calendar, leadership and location of negotiations. Nine negotiating groups, two committees and one consultative group established.
April 1998	Second Summit of the Americas (Santiago)	Heads of state launch negotiations.
Negotiation period		
June 1998	Buenos Aires Trade Negotiations Committee meeting	Vice Ministers set forth comprehensive work program for each group and committee.
September 1998		FTAA Administrative Secretary established in Miami.
September 1998		Commencement of negotiating group and committee meetings.
November 1999	Toronto Ministerial Meeting	Annotated outlines of eventual FTAA chapters reviewed; package of business facilitation measures approved; negotiating groups mandated to produce bracketed text of eventual chapters.
January 2000		Implementation of business facilitation measures begins, thereby fulfilling mandate to make "concrete progress" by 2000.
March 2001		Transfer of Administrative Secretariat to Panama City.
April 2001	Buenos Aires Ministerial Meeting	Review of bracketed text, issuance of new instructions.
April 2001	Third Summit of the Americas (Quebec City)	Public release of the FTAA bracketed text in four languages.
May 2002		Launch of product-sector specific negotiations.
October 2002	Ecuador Ministerial Meeting	
November 2002		Commencement of Brazil/United States Co-Presidency.
March 2003		Transfer of Administrative Secretariat to Mexico City.
December 2004		Conclusion of negotiations.
December 2005		Entry into force of the FTAA agreement.

EU-like institutions. Finally, progress in certain important areas of the FTAA negotiations—e.g., agricultural domestic support—may be intrinsically linked to advances in the WTO's complex Doha Development Agenda, also scheduled to finish in 2005.

While completing the FTAA will be a technical and political challenge of major proportion, it is important to note that the process is already leaving a positive legacy for the development of Latin America (Iglesias, 1999). Some of the positive externalities emerging from the launch of the process in 1995 are quite impressive. For instance, after nearly eight years of regular FTAA meetings, there is a certain familiarity and esprit de corps among the delegations that has allowed them to use FTAA fora to resolve bilateral trade problems and launch new initiatives. The process also has enhanced transparency by generating a wealth of hemispheric comparative data on national trade and regulatory norms that heretofore were unavailable or very difficult to obtain. Countries have also used the FTAA negotiations as a learning laboratory for WTO disciplines and new pioneering second-generation trade issues (e.g., competition policy and e-commerce) as well as for exploiting opportunities to hone negotiating skills through the extensive participation and leadership that the process has encouraged even for the smallest countries of the hemisphere. The FTAA process also has approved and implemented customs procedure measures to facilitate business and has fostered an emerging hemispheric business community that meets regularly around the FTAA trade ministerial.

THE NEW REGIONALISM AND THE MULTILATERAL SYSTEM

One of the major points of contention about the new regionalism has been its relationship with the multilateral system. The GATT and the WTO that succeeded it are based on multilateral principles. Ruggie (1992) has conceptualized multilateralism with the defining characteristics of indivisibility (allegiance to a system as a whole), generalized rules of conduct, and diffuse reciprocity. As Winters (2000) has pointed out, the multilateral trading system shares these characteristics: "It is indivisible in that it permits an extremely dense and far

reaching network of trade links and of intergovernmental contacts and is viewed as having an existence separate from all individual trade links between participants, and in that its separate existence is seen as valuable. The trading system's most obvious generalized norm is non-discrimination (MFN), which immediately and automatically extends bilateral agreements to all members. Reciprocity is diffuse in that governments do accept individual actions that appear not to be in their immediate interests, but it is generally accepted that, overall, every country has to gain."

Regional integration includes trade liberalization among a group of like-minded countries usually defined by some geographical boundaries. The preferential nature of regionalism makes it exceptional with respect to the MFN principle underlying the GATT/WTO, and it is in fact treated as an exception with legal rules that attempt to circumscribe the practice (Article XXIV of the GATT reinforced by its Understanding of the Uruguay Round agreements and Article V of the GATS).¹¹

Along with the formalization of the Uruguay Round's more stringent rules governing world trade in the 1990s, attention increasingly shifted toward the systemic effects of regional integration on the multilateral trading system. Concerns were raised about the discriminatory behavior of the new regionalism, which runs counter to the non-discriminatory principles of the multilateral trading system and is perceived by some as having the potential to discourage participation in the system, whose goal is the advance of worldwide trade liberalization. Thus, studies have emerged that address whether the proliferation of the multilateral trading system is in fact beneficial or detrimental to the strengthening of worldwide trade liberalization (Krugman, 1981; Summers, 1991). The concepts of either *building* or *stumbling* blocs (Bhagwati, 1991) have gained as much prominence as those of trade creation and diversion in the discussion of regional integration.

Although it is theoretically plausible that the dynamic interaction between regionalism and multilateralism could lead to the weakening of the latter (Bhag-

¹¹ The other formal exception for integration in developing countries is the Enabling Clause.

wati and Panagariya, 1996), the emerging features of the new regionalism may guarantee greater complementarity. In fact, when presenting the characteristics of the new regionalism (Yi, 1996) or when allowing for net benefits in adjusting progressively to competition in world markets (Frankel and Wei, 1996), regional integration may provide economic and political conditions for increased integration in the multilateral system, even though there is a risk that political economy incentives could jeopardize this outcome (Levy, 1997; Krishna, 1998). Moreover, the new regionalism appears to be an endogenous functional response to the growing challenges of integration with the world trading system and thus may contain a grain of systemic compatibility at its very heart. Ethier (1998) shows how successful multilateral trade rounds can actually provide incentives to pursue regionalism.¹²

Clearly there is a conflict between preferential trade agreements and the multilateral system when the former promote increased protection vis-à-vis the status quo. But is there a serious conflict when regional liberalization works in tandem with unilateral opening and implementation of multilateral commitments to take like-minded countries beyond liberalization attainable in the multilateral trading system? As the new regionalism has progressed, certain measures have been adopted in some agreements that could legitimately raise concerns, and many agreements have significant flaws. However, on balance, as pointed out by the WTO Secretariat (1995), the two processes seem to complement more than conflict with one another.

To put the relationship of the new regionalism and the multilateral system in proper perspective, it first should be remembered that the two processes generate different products each in its own way useful for promoting liberalization. The multilateral system is a world “hypermarket” involving more than 140 members that must make decisions by consensus. It establishes a floor for orderly world trade rules. Regionalism encompasses a “neighborhood” market of like-minded countries exploiting trade liberalization possibilities that go beyond the multilateral system because they are not contemplated or feasible at the world level, and which often sustain regional objectives that go beyond a commercial-only agreement such as the WTO.¹³

Second, a regional integration agreement is a second-best policy option and hence far from a perfect

arrangement. The multilateral system has been an extraordinarily important public good that has liberalized world trade after the protection of the inter-war period. But in practice, the multilateral system also has suboptimal characteristics. After more than 50 years of rounds of trade liberalization, the system has progressed relatively little in liberalizing agricultural-related trade in which many developing countries have a comparative advantage. Also, until the Doha Development Agenda, insufficient attention was paid to asymmetric capacities among countries to participate, negotiate and implement disciplines. Modern regional agreements can and often do overcome these problems, which may have elements of discrimination.

Third, Latin America and other developing regions clearly do not see regionalism as a substitute for the multilateral system. In the region, only one country is not a member of the WTO, and the system’s membership continues to expand, most recently with the accession of China. Moreover, Latin America was active in the preparation and negotiation of the Doha Development Agenda, as was the European Union and the United States, whose leadership was essential.

Fourth, there are important synergies between the new regionalism and the multilateral system that push both in the direction of liberalization. Second-generation regional agreements—whose agendas mirror WTO disciplines—serve to help countries prepare for multilateral rounds. Moreover, these agreements can be a laboratory for introducing new disciplines into the multilateral system, as NAFTA was for the Uruguay Round and as the EU and other regional agreements are in terms of substituting competition policy for anti-dumping actions. Regional agreements also can raise pressure for multilateral rounds, as third parties aim to erode preferences, or regional partners attempt to multilateralize their WTO liberalization agenda.

¹² Economic distance is equal to geographic distance and trade barriers. As successive multilateral rounds reduce the latter, the pull of geography gains greater weight, fostering regionalization of trade and incentives to pursue regionalism.

¹³ Even a simple free trade area in goods goes beyond the WTO because it must be in accord with Article XXIV, which aims to eliminate trade barriers on substantially all trade.

Fifth, regionalism needs the WTO to complete agendas—such as reducing domestic support in agriculture—that are difficult or impossible to negotiate at the regional level.

The central problem would seem to be that the multilateral system treats regionalism as an exception rather than a vital component of a liberalized world trading system. This ambivalence was understandable during the era of the old regionalism, with its vocation for protection. But it seems inappropriate in the context of the new regionalism and in a world where more than 50 percent of global trade passes through regional agreements. The only WTO members not having a regional agreement are South Korea and China (including Hong Kong). A better alternative might be to thoroughly embrace regionalism with a comprehensive and better-defined set of rules that promote its potential benefits and minimize its costs to partners and the world economy.

As reported by Serra et al. (1997), the Understanding on Article XXIV of the Uruguay Round reduced but did not eliminate the considerable ambiguity in multilateral regional rules. For instance, the exact amount of total regional trade that must be reciprocally liberalized to be consistent with the WTO remains open to interpretation, as does the determination of the level of protection afforded to a new customs union that would be no more restrictive than the former MFN rates. Incorporation into Article XXIV of treatment of rules of origin would be a major advance, given their powerful potential for serving protectionist interests (Estevadeordal, 1999). Treatment of non-tariff barriers and non-compliance with agreed disciplines are other gaps in the article. Finally, a better WTO monitoring capability is also needed. Hopefully, some of these issues will be addressed in the regional rules negotiation that is part of the Doha Development Agenda.

APPENDIX 2.1

EVALUATING HEMISPHERIC FREE TRADE AGREEMENTS: A COMPUTABLE GENERAL EQUILIBRIUM APPROACH¹

A crucial element for policymaking is to accurately assess and compare the impact of a country's different trade liberalization options. Among the various methodologies available to policymakers, computable general equilibrium (CGE) models have been widely used in trade policy evaluation and for other policies. Being necessarily a simplified representation of the whole economy, they capture both the aggregate and sectoral impact of policy changes on the economy under study as well as the partners. This is its distinguishing feature vis-à-vis other types of economic models.

The model enables us to evaluate the impact by comparing the economies' initial situation (benchmark equilibrium computed from the country's or countries' real data) with the new numeric equilibrium resulting from the adoption of the policy change under study. Although the adjustment time is not specifically mentioned, it is assumed to be long enough for the markets to readjust and thus achieve the new equilibrium. The addendum to this note contains a more detailed description of the model as well as its main advantages and disadvantages.

CGE simulations were used to evaluate and compare the differentiated effect of alternative trade agreements involving Latin America, including the FTAA and free trade agreements between the Mercosur and Andean Community countries with their two major partners (the European Union and the United States). All the agreements considered are either being negotiated or have been announced. Since part of the recent discussion on the new regionalism has been concentrated on the relative advantages of North-South versus South-South agreements (Venables, 2001), the results will also provide some insight on this issue.

The CGE model used is a multi-country and multi-sector comparative static model that incorporates trade-linked externalities and economies of scale in the manufacturing industries. The policy variables in this exercise are the elimination of tariff protection (including ad valorem as well as specific, mixed tariffs and

tariff-rate quotas),² export subsidies, and producer support estimates (for the NAFTA countries and the EU). One should note that market access is only one part of the potential net benefits of a free trade agreement, and hence simulations are a very conservative estimate of effects.

Appendix Figures 2.1a and b compare the impact of the three agreements for Mercosur and the Andean countries. They show the percentage increase in exports that a free trade agreement with the EU, the United States and the FTAA would have on the economies. For simplicity, we aggregate the 15 sectors into three broader groups: primary goods, light manufactures and heavy manufactures. Although the high degree of aggregation makes for an imprecise definition of these groups, they are relatively correlated with the relative use of factors: primary industries are land-oriented, light manufactures are labor-oriented and heavy manufactures are, in general, capital-oriented.

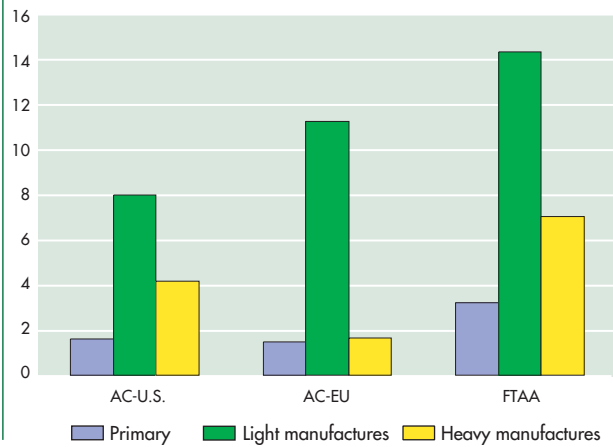
In terms of scenarios, the highest impact on export growth for Mercosur would be the free trade agreement with the EU (12 percent increase), followed by the FTAA (8 percent increase). For the Andean Community, the FTAA would bring an increase in exports of 6 percent, while an agreement with the EU would increase exports by 3 percent. Although there are many reasons behind these results, they are very much affected by the initial trade links between countries engaged in an agreement (for example, as a destination market, the EU weighs heavier for Mercosur than for the Andean Community), and by the initial trade protection faced by countries. In any event, both the EU and the FTAA are important enough markets that pursuing free trade agreements should not be interpreted as an either/or proposition.

The analysis by sectors shows that in all scenarios light manufactures are the faster growing sector, although the relative impact is bigger under a free trade agreement with the EU than in the other two scenarios considered. As expected, light manufactures is

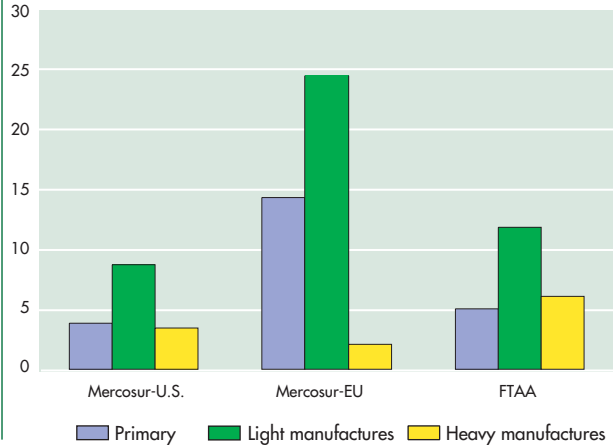
¹ Results presented in this appendix come from Montenegro and Watanuki (2002).

² Although most tariffs are ad valorem, non-ad valorem tariffs are frequent for agriculture products, especially in the most developed countries.

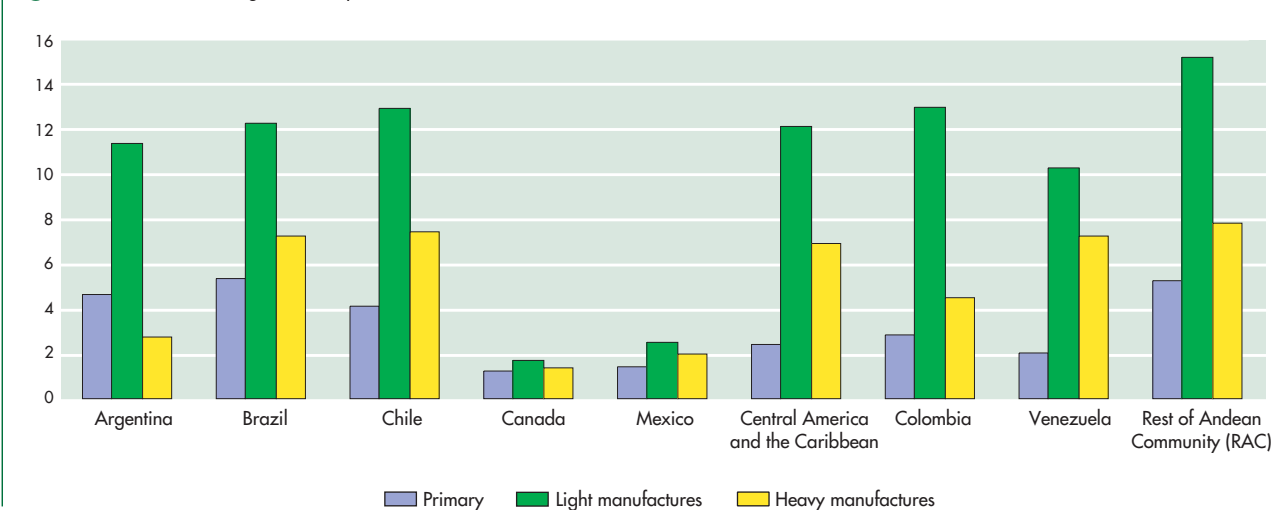
Appendix Figure 2.1 a Impact of Potential Regional Integration Agreements on Andean Exports
(Percent of exports)



Appendix Figure 2.1 b Impact of Potential Regional Integration Agreements on Mercosur Exports
(Percent of exports)



Appendix Figure 2.2 Change in Exports under FTAA
(Percent growth of exports)



led by agriculture-related products (meat and processed food) that are among the sectors facing the highest protection in both the U.S. and EU markets. This result confirms the subregion’s comparative advantage in terms of an agreement with more developed countries. As expected, the FTAA reflects the same pattern of growth across macro-sectors as does the agreement with the United States: specialization in light manufactures, followed by heavy manufactures and then primary goods, reflecting in part that the primary sectors are relatively less protected in the Western Hemisphere compared with the EU market. In most cases, the increased heavy manufacturing exports in Mercosur and the Andean countries are resource-based manufactures.

Appendix Figure 2.2 presents the impact of the FTAA by macro-sector. Total export growth ranges from 4 percent to 9 percent across Latin America, except for Mexico (2 percent) because of NAFTA. By sectors, all of the region’s countries considered (except Venezuela) specialize relatively more in light manufactures exports (mainly textiles in the Central American and Caribbean group, processed food and other light manufactures in the Mercosur countries, and a more mixed combination for the Andean countries). The heavy manufacturing sector follows as the second fastest growing sector, made up mostly of new exports of automobile and machinery equipment from Brazil and more natural resource-based heavy manufactures such as petroleum in Venezuela and Argentina (also

chemicals in this case), and iron and steel in the group formed by Bolivia, Ecuador and Peru (RAC).

Finally, an interesting result is to see what difference the presence of Latin American countries makes in the FTAA. Appendix Figure 2.3 shows first that more than 40 percent of the new exports will go to the regional market for all countries, except for Central America (as a result of its high dependence on the U.S. market). The colored cells show the cases where the share of Latin American countries in increased exports is more than 50 percent. Another result worth mentioning is that for primary goods exports, the regional market absorbs more than 50 percent of new exports; these percentages rise to 69 percent for light manufactures and to 72 percent for heavy manufactures. To the extent that specializing in manufactures is an attractive strategic consideration, this is an important result to bear in mind when addressing the importance of the intra-Latin American market in the FTAA negotiations.

METHODOLOGICAL ADDENDUM TO APPENDIX 2.1: THE USE OF COMPUTABLE GENERAL EQUILIBRIUM MODELS IN THE EVALUATION OF TRADE LIBERALIZATION POLICIES

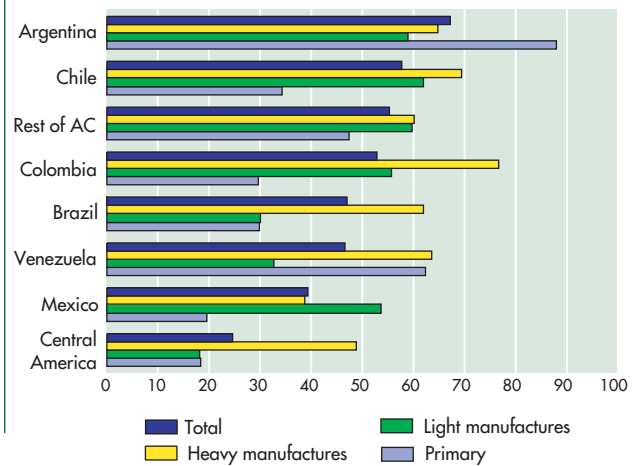
Basic Features of CGE Models

CGE models are based on the general equilibrium theory in which equilibrium prices and quantities are determined *simultaneously*. CGE models are nevertheless a simplified representation of the economy and only identify key economic actors or agents (such as households or consumers, firms or producers, and government).

CGE models are *equilibrium* models because they describe the behavior of the economy as the outcome of supply and demand for each product in each market, allowing prices to adjust so that supply and demand exactly match. There is no excess demand or supply, and all markets simultaneously clear, i.e., supply equals demand.

CGE models are *general* equilibrium models because they capture all the sectors in an economy and all the economic agents involved. This is the most striking advantage of CGE models compared with partial equilibrium models. Consequently, CGE models can

Appendix Figure 2.3 Importance of Latin American Exports in the FTAA
(Percent of total exports to FTAA)



specifically examine the efficient use of resource allocation and the equity with which such resources are redistributed.

CGE models are *computable* models in that they provide a unique equilibrium solution and are quantified in a numerical way rather than by analytical means. This provides a precise measurement of the economic impact of a given policy.

What the CGE Captures

The CGE model captures the main effects of a trade liberalization predicted by standard theory of international trade:

- **Trade effects:** Tariff elimination causes an increase in imports and improved efficiency in the medium term due to the fact that the elimination of the tariff distortions will lead to an increase in exports.
- **Production effects:** Producers (firms) adjust production structures according to a new set of prices and factor returns along with their respective production possibility frontiers.
- **Government revenue effects:** In the short term, the government loses total revenues due to the reduction in tariff revenue; if not offset by alternative revenues, this decrease may lead to a decline in public spending.
- **Welfare effects:** Real household income is affected by a change in real wages and the price of

other factors (capital and land), as well as that of goods and services. All these factors presumably will increase welfare.

Main Advantages

Noteworthy among the advantages of using CGE models for economic policy analysis are that they:

- Allow policymakers to assess the specific impact of the various policy options under consideration by controlling the effects of other policy instruments.
- Take into account the complex interdependent connections that exist in real economies, or interactions among the sectors, households and with trade partners, which is different from partial equilibrium analysis.
- Explicitly model the entire economy.
- Examine the impact on resource allocation, equity and income distribution.
- Measure changes in welfare.
- Simulate policy alternatives.
- Provide numerical results so that alternatives can be compared and the available policy options easily ranked.

Main Disadvantages

CGE models do of course have disadvantages, although they share some of them with other methods of economic policy evaluation such as input-output, linear programming, optimal control and macroeconomic models. Some of the disadvantages concern model construction. CGE models are complex to con-

struct because of the large amount of data they use (national accounts, input-output tables, trade flows, balance of payments, etc.). Much fine-tuning and adjustment of the data is needed in order to construct a compatible and consistent benchmark database.

Other disadvantages are related to the implementation of the model. CGE models are highly dependent on the benchmark data (i.e., on the economic conditions in the base year), and they are very sensitive to certain parameter estimations or assumptions (such as elasticities).

Lastly, the results of CGE models must be carefully interpreted because they do not consider any other economic policy action or shocks during the period of adjustment of the economy to the new equilibrium, and because they do not reflect non-economic effects (such as institutional impacts). Finally, most CGE models deal with the real side of the economy, excluding monetary or financial variables and dynamic effects of capital accumulation.

Characteristics of the CGE Model Used

The model comprises 12 countries or regions. Each of these 12 economies includes 15 sectors grouped into three main macrosectors: the primary sector, light and heavy manufactures, and services. Among the main features of the model is that it includes positive externalities linked to trade flows, reflecting the idea that trade liberalization leads to increased productivity. To some extent, this feature offsets the static nature of the model (since it does not reflect capital accumulation from one period to the next). The benchmark year for this model is 1997.

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