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The New Regionalism

Regionalism is not new for Latin America. Even before independence, Simon Bolívar was calling for a political union of countries around the continent. Attempts at economic integration have included 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).

So what's new about the current wave of regionalism? Perhaps the best way to understand this new regionalism is to contrast it with the old brand of regionalism. The old regionalism was born and died with the import-substitution industrialization (ISI) strategies that dominated Latin America's early post-war development policy and theory: regional integration was viewed as a strategic tool for strengthening ISI. The approach aimed to eliminate trade and investment barriers among partner countries, maintain or raise protection against third parties, extend planning and state intervention to a regional level, and regulate foreign direct investment with a collective institutional architecture inspired by European integration.

By the mid-1970s, the processes showed signs of fatigue. Some of the key obstacles included national protectionism, tension between the state and the private sector, macroeconomic instability, sparse regional infrastructure, authoritarian governments and U.S. skepticism with the process. By the mid-1980s, the ISI approach to development and integration had become a relic of the past.

The defining difference between the new regionalism of the 1990s and the earlier post-war experiences is the policy environment. In effect, the new regionalism was inserted into a framework of policy reform that promotes open and competitive market-based economies in a modern democratic institutional setting. Perhaps the most dramatic change was the shift during the 1990s from the traditional intra-regional focus to growing interest in inter-regional, and in particular, North-North agreements. This would have been politically inconceivable under the old regionalism.

The new regionalism is generally viewed as having the following objectives:

- ♦ Strengthening structural economic reforms.
- ♦ Economic transformation. Reciprocal openness, guarantees of market access, preferences, and other aspects of a regional scheme can provide new opportunities for exporting and diversification and thereby serve as a stepping stone to compete more effectively in a global economy.
- ♦ Attracting foreign direct investment (FDI).
- ♦ Geopolitics. A group of like-minded countries can use a regional agreement to establish a regional safety net for fragile democracies.
- ♦ Functional regional cooperation. Beneficial economic interdependence among partners typically brings about additional regional cooperation in other areas, such as the provision of regional infrastructure or other public goods.

While offering these potential benefits, regional integration agreements (RIAs)

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This issue of *Latin American Economic Policies* is based on the 2002 *Economic and Social Progress Report* titled "Beyond Borders: The New Regionalism in Latin America." The newsletter features research by Robert Devlin, Suzanne Duryea, Antoni Estevadeordal, Mauricio Mesquita Moreira, Raymond Robertson, and Ernesto Stein.

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The Spaghetti Bowl of Trade Liberalization

The story of trade liberalization is a story of market access. But it's not always easy to follow the story line. Starting in the 1980s, most of the developing world moved toward substantial market-oriented economic reforms including unilateral trade liberalization policies. At the same time, multilateral efforts in Geneva to liberalize trade in goods and services culminated in the Uruguay Round Agreements of 1994 and the creation of the World Trade Organization in 1995. The plot thickened as regionalism took hold around the world, especially in Latin America, and manifested itself in traditional regional initiatives or newly crafted preferential trade agreements.

Today, the region is home to 30 reciprocal agreements plus some partial agreements, all of which are linked to the objectives of the "new regionalism" approach and superimposed on a background of unilateral policies and multilateral agreements. However, each country has pursued its own strategic trade objectives through different trade agreements that have their own tariff reduction schemes, rules of origin, and technical, procedural and even documental systems. This has given rise to what some have

dubbed the "spaghetti-bowl" effect of trade agreements (see Figure 1).

Because governments have largely abandoned across-the-board tariff protectionism, they are increasingly seeking other restrictive trade instruments that can be used at the sectoral level. This explains the burgeoning interest in rules of origin and other non-tariff measures

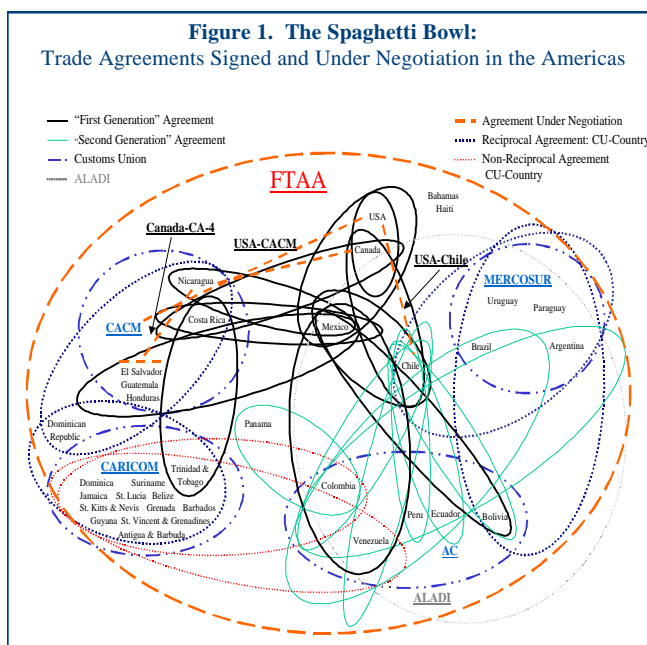
for protective purposes.

Have those preferential trade agreements mattered for the pattern of trade? A study by Estevadeordal and Robertson (2002) finds that tariff elasticities (the percent change in trade volumes induced by a 1% change in tariffs) matter almost as much as distance, an important factor behind bilateral trade flows. Thus, while countries cannot change their locations, they can change their trade policies. For example, Chile, whose distance from most industrialized markets is a geographical disadvantage, has experienced a surge in bilateral trade after signing several bilateral free trade agreements (FTAs).

Rules of origin are another important consideration. Under an FTA, each country maintains its own external tariffs vis-à-vis the outside world. As these barriers differ, there is always the incentive to import a good through the country with the lowest barriers. Rules of origin are required to prevent such trade deflection. They specify the conditions goods must meet in order to be deemed as "originating" and hence be eligible for preferential tariff treatment.

"Hidden" protectionism in rules of origin can induce producers to switch from low-cost non-regional to high-cost regional inputs

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(NTMs). The countries of the region gradually eliminated quantitative limits on imports both unilaterally and within the framework of multilateral commitments. There remains, however, trade regulation that could potentially restrict trade, such as government purchasing arrangements, inappropriate use of anti-dumping measures, and the increasing use of competition policies and technical measures

RIAs and FDI: What's the Link?

Just as regional integration agreements (RIA) have sprouted up around the world, flows of foreign direct investment (FDI) have surged. While world trade has doubled over the last two decades, flows of FDI have increased by a factor of ten. Clearly, countries are anxious to understand the links between RIAs and FDI as subregional agreements proliferate and the Free Trade Area of the Americas (FTAA) looms on the horizon.

These links are not necessarily obvious. A firm may invest abroad in order to serve a protected market. Integration reduces trade barriers and thus weakens the firm's motive for "tariff-jumping" FDI. Alternatively, a firm may invest abroad in order to exploit different countries' comparative advantages in production. Following certain stages, a good will cross national boundaries and incur tariff costs; integration reduces such costs and thus encourages this type of FDI.

Data on bilateral FDI stocks from the OECD *International Direct Investment Statistics* was used to look at the impact of RIAs on FDI. The dataset covers FDI from 20 OECD source countries to 60 host countries from 1982 through 1998.

The first question is whether a host country that shares mem-

bership in an RIA with a source country will receive more bilateral FDI from that source.

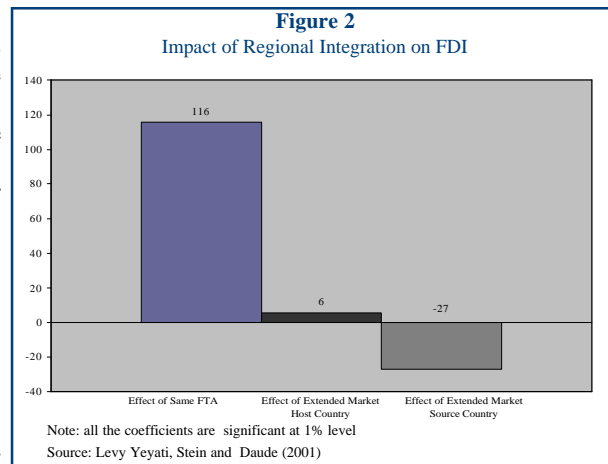
A second question is whether expanding a market through regional integration attracts more FDI. For example, do countries in Mercosur receive more FDI from outside sources following integration? To capture this effect, the variable *Extended Market Host* measures the size of the extended market of the host country. For example, for Brazil in the years before Mercosur,

A third question is investment diversion—and investment dilution—when the source country expands its own RIA. For example, does Costa Rica receive less FDI from the US following NAFTA? Does Mexico lose with the FTAA, as its preferential access to the US and Canada gets diluted? These issues are addressed by a third variable, *Extended Market Source*.

The main results of this exercise, illustrated in Figure 2 are dramatic indeed. The first bar shows that forming an FTA with a source country increases the stock of FDI from that country by 116%. The possible FDI loss due to tariff-jumping is more than offset by other effects.

The second bar captures the impact of the host extended market effect. Doubling the size of the extended market increases FDI from all sources by nearly 6%. While this effect may seem small, sometimes the increase in the size of the extended market is very large: when Mexico entered NAFTA its extended market swelled by a factor of 18. Finally, the doubling of the extended market of the source leads to an expected decline in the FDI stock originating from that country of nearly 27%.

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Extended Market Host takes the value of Brazil's GDP at the time; after Mercosur, it takes the value of the four Mercosur countries combined, as extending the market may increase FDI multinationals from outside the region to "jump" the external tariff. On the other hand, the gains are unlikely to be distributed evenly, as a firm that was producing in each of the countries may decide to consolidate production in a single location following integration.

Trade Agreements, Exchange Rate Disagreements

What happens when partners in RIAs have divergent exchange rate policies? A look at recent experience in the Southern Cone Common Market (Mercosur) highlights just how hair-raising the situation can be. The January 1999 devaluation of the Brazilian real strained the relationship between Argentina and Brazil, setting off a series of events that included protectionist measures in Argentina, Argentine businesses threatening to relocate or actually relocating in Brazil, and additional pressures on the Argentine peso. Although clearly not the only factor, the real devaluation contributed to the end of Argentina's convertibility in December 2001. In turn, the crisis in Argentina had serious consequences for Uruguay and Brazil.

Problems such as these, however, are not unique to Mercosur. They typically emerge when countries have trade agreements but exchange rate disagreements; that is, large swings in bilateral real exchange rates.

Similar problems occurred in the European Union after the Exchange Rate Mechanism (ERM) crisis of 1992. But there is a difference. In Europe, the crisis occurred in spite of—or as a result of—the failure of attempts to coordinate exchange rate policy among member countries. In contrast, there have been no such efforts to coordinate exchange rates in most RIAs in the Americas or around the world.

The types of problems that emerge include the following:

- ♦ *Increased protectionism and the scaling back or elimination of trade arrangements:* The country that loses competitiveness may resort to increased protectionism. The RIA may preclude the country from increasing tariffs within the bloc. Consequently, the country may increase protection vis-à-vis the rest of the world, or it may increase protection vis-à-vis the bloc partners by resorting to less transparent methods such as antidumping, sanitary restrictions, or other administrative measures. Countries may also scale back or even abandon their trade arrangements.

- ♦ *Reduction in trade flows:* Exchange rate disagreements could lead to reduced exports from the country that loses competitiveness. If the disagreement occurs in the context of an RIA with high external protection, trade among partners may not reflect true comparative advantage, and it may be difficult for the country that loses competitiveness to redirect exports to alternative markets.

- ♦ *Relocation of investments:* RIAs may spark intense competition for the location of investment. Eliminating trade barriers may induce firms to produce in a single location within a bloc, and serve the extended market from this location. This intensifies competition for foreign direct investment (FDI). Under these conditions, swings in bilateral real exchange rates may affect the

location of new investment and shift the location of existing investment as well.

- ♦ *Exchange rate crises:* Depreciation in one member country may reduce the credibility of the partner's commitment to a fixed parity and can generate speculative attacks on its currency. A country may thus be forced to abandon its preferred exchange rate policy due to the exchange rate disagreement. This problem may be particularly relevant during periods of financial turmoil, when access to financial markets is hindered.

A large depreciation in a country may lead to reduced exports, loss of investments and contagion in the country's partners, whether these belong to the same RIA or not. Fernández-Arias, Panizza and Stein (2002) show that common membership in RIAs exacerbates these problems. The effects of overvaluation on exports are four times larger when the source of the overvaluation lies within the RIA members, suggesting that exports to RIA partners are more difficult to relocate to alternative markets. Increases in flows of foreign investment to a country following depreciation have a larger negative effect on its RIA partners, who become relatively less attractive to foreign investors. And the impact of overvaluation on the probability of a crisis increases substantially when the overvaluation is due to exchange rate developments in RIA partner countries.

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Trade Agreements, Exchange Rate Disagreements

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In fact, a 10 percent overvaluation explained by exchange rate movements within the RIA increases the probability of a crisis within the next month by 4 percentage points; a similar overvaluation explained by movements of the exchange rate vis-à-vis non-RIA partners increases the probability of a crisis by just 1.7 percent. Exchange rate disagreements thus have the potential to break up or weaken support for RIAs.

What can be done? There are three types of policies that address the risks associated with exchange rate disagreements: *unilateral policies* by countries to make themselves less vulnerable to exchange rate disagreements within RIAs, including using exchange rate compatibility as a criteria for choosing RIA partners; *macroeconomic policy coordination* among RIA members, ranging from a monetary union at

one extreme to simply avoiding the coexistence of inconsistent regimes (such as pegs and floating regimes); and, *adequate international financial architecture* to facilitate international trade, reduce the risks of exchange rate disagreements in RIAs and ensure international financing to smooth out temporary shocks.

The New Regionalism

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require adjustments and bear potential costs. Some of these costs include:

- ♦ *Trade Diversion.* Preferences in RIAs (coupled with rules of origin in free trade areas) can potentially divert trade away from more efficient locations in non-member countries. The open character of the new regionalism, in which liberalization at the preferential level coexists with liberalization at the unilateral and multilateral levels can mitigate this effect.

- ♦ *Vulnerability of Regional Goods.* A regional agreement can create trade but at the same time, due to preferential access, support regional trade in goods that are not competitive in the rest of the world. This may leave members vulnerable to recession or exchange rate depreciation in the regional market, since the region-

al goods exports cannot be easily redirected to alternative markets.

- ♦ *Asymmetric Impact.* In the absence of corrective mechanisms, the development benefits of regional integration are often distributed unevenly among members.

- ♦ *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.

- ♦ *Investment Diversion.* While enlarged regional markets and preferences can attract foreign direct investment (FDI), they could divert FDI from more efficient locations.

- ♦ *Other Costs.* It has been argued that the emergence of

agreements can create a “gang effect” that leaves outside countries with little choice but to join the agreement for fear of trade and investment diversion.

Regional integration is not an end in itself but a means to other ends. Hence, not all regional integration initiatives make economic sense, and even those that do can go awry. Evaluating the costs and benefits of initiatives is the only way to determine whether an agreement makes sense for the participating countries and the rest of the world. This issue of *Latin American Economic Policies* draws from the 2002 Economic and Social Progress Report (*Beyond Borders: The New Regionalism in Latin America*) to look at some of the issues surrounding the new regionalism.

Regional Integration and Productivity: A Tale of Two Countries

Integration can be the handmaiden of productivity growth, either through trade or foreign investment. That's what economic theory suggests and what policymakers in Latin America are hoping as they advance in their trade negotiations. This potential for productivity gains is particularly important for a region that, with few exceptions, has a dismal record in this regard and has been struggling in recent decades to get back on a sustainable growth path. The theory also suggests that both global and regional integration can offer substantial productivity gains. According to the bigger-is-better rationale, global integration offers larger potential gains because it involves larger markets and a broader spectrum of comparative advantages. Regional integration, though, can be a strategic stepping-stone to global integration by speeding up negotiations, mitigating adjustment costs and offering safeguards against the downside risks of integration.

Against a backdrop of scarce evidence, the stories of Brazil and Mexico shed some light on the links between productivity and integration and on the nuances of different strategies of regional integration. Both Brazil and Mexico moved towards integration after at least half a century of import-substitution policies. Mexico moved first and faster, and by the early 1990s had already made substantial progress. Manufacturing tariffs fell from around 30% in 1985 to 15.5% in 1993, and declined even

more following Mexico's entry into NAFTA in 1994; by 2000, less than 1% of manufacturing imports faced duties of 10% or higher. Brazil, by contrast, took longer to open up. The removal of nontariff barriers and a drastic drop in tariffs had to wait until 1990. As in Mexico, trade liberalization was deepened by a regional trade agreement, Mercosur, but this was a South-South agreement as opposed to Mexico's North-South experience in NAFTA. In both countries, liberalization was accompanied by FDI deregulation.

Productivity growth in manufacturing was positive in both countries, reversing a downward trend that prevailed until the 1980s. In addition, neither showed signs of a change in the composition of economic output that would indicate economies of scale losses or damage to knowledge-producing sectors.

Reallocation effects accounted for most of the productivity growth in both countries. These reallocation effects were of two types: intra-industry adjustments in market share between low and high productivity firms within the same industry and inter-industry changes brought about by shifts in the composition of manufacturing output.

The direct evidence on trade-productivity links reveals import-discipline as the dominant effect. Competition from imports affects productivity in at least three ways: by reducing the slack in firm management; by forcing

firms to increase their output and therefore improve their scale efficiency; and by increasing firms' incentive to innovate.

Regarding the strategy of regional integration, Mexico's more aggressive stance with NAFTA seems to have paid off, at least with respect to productivity. Tariff reductions as part of the agreement appear to have had a sizable positive impact on productivity growth, which added to the already substantial gains reaped during the period of non-preferential global liberalization. As theory suggests, differences in labor costs among NAFTA partners seem to have kept the threat of painful dislocations in increasing returns and knowledge-intensive sectors at bay.

On the other hand, there is not enough evidence to argue that Brazil's more cautious approach to trade was misguided. The fact that the preferential liberalization with its neighbors and the non-preferential liberalization were carried out simultaneously makes it very difficult to disentangle regional and non-regional effects. What one can argue is that the lion's share of Brazil's productivity gains during this period came from non-preferential liberalization, given that Mercosur at its peak did not account for more than 17% of Brazil's total trade. And this comes as no surprise in view of the relative size and resources of Brazil's partners in the regional agreement. The evidence points to learning-by-

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The Spaghetti Bowl of Trade Liberalization

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to take advantage of preferential rates. Thus, restrictive rules may provide additional protection to regional producers of intermediate goods, to the detriment of downstream or final goods producers.

Moreover, outside producers of intermediate goods hurt by restrictive rules may have an incentive to move production facilities into the lowest cost country within the region, even though it is not the lowest cost producer worldwide.

Agriculture is a particularly thorny issue. Despite the achievements of the Uruguay Round on Agriculture, the farming sector is still the most protected in the world economy. Protection through ad valorem tariffs contin-

ues to be the main form of protection; however, agricultural products are also protected through specific and compound tariffs, tariff rate quotas, sanitary restrictions, domestic and export subsidies, and many different types of non-tariff barriers.

The FTAA faces a difficult job in defining the terms of coexisting with the spaghetti-bowl of trade agreements in the hemisphere. How can countries deal with current and potential market access conditions for the goods that will benefit from this complex set of trade agreements, each with its own tariff reduction schemes, rules of origin, and technical, procedural and even documental systems? Indeed, FTAA negotiators have a full plate before them.

However, three scenarios are most likely: (i) the FTAA negotiates its own tariff elimination program, its own set of rules of origin and its own requirements, while exporters decide on a case-by-case basis whether to opt for FTAA treatment or for treatment in accordance with another agreement; (ii) the FTAA supersedes pre-existing agreements, making FTAA criteria the only valid ones; (iii) the FTAA does not step in to regulate tariffs, origin or procedural requirements among countries that already have a trade agreement in force. Each option has advantages and disadvantages. Still, if the FTAA manages to rationalize the spaghetti bowl, it will have achieved something that was not even on the menu.

RIAs and FDI: What's the Link?

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The magnitude of these effects is shown by the FTAA's estimated impact on FDI from the U.S. to Mexico and Argentina. Since it does not have an RIA with the U.S., Argentina would benefit from sharing an RIA with the source. In addition, the Argentine economy would become more attractive to FDI because its market would expand from Mercosur to the FTAA. While the source extended market effect would partially offset these increases, the creation of the FTAA would translate into a 165% increase in the United States' direct investment position in Argentina.

The result for Mexico would be quite different. Since Mexico and the U.S. are already members of NAFTA, the FTAA would have no direct effect on U.S.-originated FDI. There would be an indirect effect, however, due to the 13% extension of Mexico's market from its existing free trade agreements to the FTAA, corresponding to an increase of U.S.-originated FDI of only 0.75%. Netting the source extended market effect (-4.3%), the overall decline of U.S. FDI stocks in Mexico would be 3.5%. While this small loss may be partially compensated by additional FDI

from other sources, since the US is by far the biggest FDI player in Mexico, this country could lose FDI as a result of the FTAA.

The stark contrast between these two pictures highlights potential asymmetries in the impact of the FTAA. Impacts may also differ according to the countries. Countries that are more open, more similar in factor endowments to the source countries and present a more attractive overall package for FDI, benefit more from RIAs.

Trade and Inequality: Putting Aside the Passion

Passions run high when it comes to the debate on trade liberalization and inequality. Anti-globalization demonstrators in Seattle, Genoa and most recently Washington, DC decry trade liberalization as a force that widens the gap between the haves and have-nots, among and within countries. At the other end of the ideological spectrum, trade theorists are equally adamant that free trade is an engine of growth and that welfare gains are shared by all segments of society. As is often the case in such debates, the truth lies somewhere in between.

Unfortunately, the evidence is not clear-cut, meaning there is no consensus about the long-run effects of trade liberalization on wage inequality. Even less is known about wage behavior in the specific context of regional integration. True, some Latin American countries showed a rise in the skill-gap following trade liberalization, but it is risky to conclude that the less-skilled lose disproportionately from trade. To begin with, some evidence suggests that the skill-gap rises in the short run, but falls back over time. That was the pattern in Chile, where wage inequality rose from 1970 to 1990 and then began to fall. Mexico experienced a similar reversal that

is easier to explain. Figure 3 shows that wage inequality rose in Mexico after it joined GATT, but fell following its entrance into NAFTA. This supports the theory that the type of integration matters (North-South vs. South-South). The GATT liberalization brought

workers with tertiary and secondary education may not be the most useful yardstick. The supply of workers with secondary education has increased dramatically throughout Latin America. This surge in supply may have depressed their wages more than changes in the demand for skill. Taking workers with secondary education out of the equation paints a very different picture. When the wage-gap between workers with university versus elementary education is examined, there is no consistent evidence that the less-skilled have lost ground.

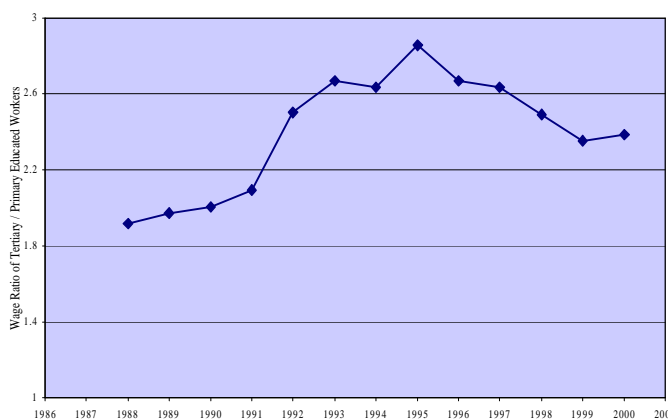
Finally, some studies suggest that the direct

effect of trade on goods and factor prices may actually be quite small. Rather, trade attracts technology and foreign direct investment, which then affect wage inequality.

The stylized facts on the wage gap between skilled and unskilled workers contrast with the widespread view that less skilled workers in the region are consistently leaving their more skilled counterparts behind. Moreover, the relative decline in

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Figure 3.
Wage Ratio of Tertiary/Primary Educated Workers
(Mexico, urban males ages 18-65)



Source: Hernani, Werner (2002) based on Encuestas Nacional de Empleo Urbano.

Mexico into competition with the world, while the NAFTA liberalization only involved the North. Mexico is not necessarily abundant in less-skilled workers compared to world trading partners such as China, but it is less skilled compared to the United States and Canada. Interestingly, GATT and NAFTA also had different effects on another dimension of inequality—the geographical distribution of employment in manufacturing.

Another issue to consider is that measuring the skill gap in terms of the wage gap between

Trade and Inequality: Putting Aside the Passion

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the wages of workers with secondary school, compared to their counterparts with primary or tertiary schooling, suggests that these patterns may be related to the increased supply of workers with secondary school or a decline in the quality of secondary school. Although there is evidence of a rise in the return to very highly skilled labor (university educated) in numerous countries, the pattern found for Panama, Honduras and Argentina conflicts with perceptions.

POLICY, INSTEAD OF PASSION

Given the ambiguous results of the research, it is senseless to take a stand at either end of the ideological spectrum. It makes far more sense to focus on what is known: regardless of whether further integration is North-South or South-South, economic integration causes a reallocation of resources among industries. For this reason, policies should focus less on trying to reduce the wage gap between skilled and unskilled workers and more on helping workers and families adjust to changes in the labor market.

♦ *Worker training and job search programs* that smooth transitions to new types of employment will help workers become more productive sooner. The availability of effective programs prior to further rounds of liberalization will also help ease workers' fears regarding integration.

♦ *Unemployment Insurance and Workfare Programs.* The hefty severance payments typical of unemployment insurance schemes in the region slow the reallocation of workers to new positions as employers hold on to inefficient staff to avoid paying the stiff penalty (Heckman and Pagés, 2002). On the other hand, unemployment insurance as implemented by most developed countries, with smaller monthly payments, is often criticized for discouraging labor supply. A new hybrid unemployment insurance in Chile directs a share of wages and the employer's contribution to individual accounts. Workers first draw down their personal accounts before receiving government payments. Since unused contributions roll over to retirement accounts, the worker has the incentive to conserve the account. These schemes are also portable from job to job, an attractive feature in dynamic economies.

Employment programs in which participants receive a minimum wage in exchange for work have advantages over standard unemployment insurance since unemployment transfers are typically only available for formal sector workers and provide a disincentive to work. Workfare programs are more expensive to administer than cash transfers but do not discourage labor supply. Unfortunately, using discretion based on political objectives to allocate positions often compromises the effectiveness of the program.

Providing credit and training to small and medium-sized enterprises is important for directing displaced labor towards more efficient production. Promoting exports, ties to foreign markets, and new technologies may help increase worker productivity in ways that are necessary for long-run improvements in living standards.

♦ *Promotion of Agricultural Competitiveness.* Worldwide trade liberalization in agriculture is critical for making trade work for the poor. And low prices are not the only problem. Technology and production alternatives are lacking, especially in tropical countries where agriculture has been protected. Countries can also provide assistance to small and medium firms to help them meet the standards required for exporting their agricultural products.

♦ *Education.* The education of the next generation of workers should be a priority. A labor force with a high level of general skills will be best placed to take advantage of or weather the adjustments from changes in international prices and advancements in technology. While the temptation exists to maintain protection for highly mobilized or vulnerable groups, delaying the dismantling of protection creates new generations of potential workers with misaligned skills.

An Agenda for the Future

Multiple objectives on multiple fronts—simultaneously. The agenda for Latin American and Caribbean countries as they advance in their regional integration strategies is nothing short of a juggling act. The new regionalism's three fronts for action are North-South initiatives, the subregional integration process and the multilateral Doha Development Agenda. Success on each front is a feat in its own right and as it influences the other two areas.

NORTH-SOUTH INTEGRATION

A major objective of Latin America's regional integration agenda is completing the Free Trade Area of the Americas (FTAA) in a way that balances the interests of all parties. Why is the FTAA so important? Clearly, guaranteed reciprocal access to the markets in the Americas matters to all countries in the region. For Latin America, effective market access means dismantling existing barriers in the industrialized markets of the North, applying secure and predictable contingent protectionist measures, and setting up an efficient dispute settlement procedure. In market access negotiations, agriculture is a high-priority, but sensitive, sector. Hopefully, major inroads will be made in the FTAA negotiations, but a full response may have to wait until agricultural negotiations are concluded in the parallel Doha Development Agenda.

The FTAA may also help lock in the structural reforms that

are currently being questioned in several countries in the region. Politically, the FTAA may help boost U.S. cooperation with Latin America as it increases U.S. stakes in the region. Together, improved market access, enhanced credibility of economic reforms, and a greater U.S. focus on the region may add up to a big difference in the prospects for development in Latin America. A comprehensive and balanced FTAA could serve as an anchor for Latin American economies, boosting their credibility in financial markets.

But Latin America's eyes should not be fixed exclusively on the U.S. Like the FTAA, free trade agreements with Europe could make subregional blocs more open and reduce risks of trade diversion. For instance Mexico pursued an agreement with the EU to minimize residual trade diversion, diversify to new export markets and attract European FDI and know-how. The Chilean agreement with the EU, as well as participation by Mexico, Chile and Peru in APEC, are similarly inspired.

Since many Latin American countries trade as much with Europe as with the United States and Canada, the benefits of trade liberalization vis-à-vis the EU would at least equal those from the FTAA. In addition, the EU offers a model of North-South integration in which well-funded cooperation plays an integral role. Links to the EU also offer opportunities to learn from Europe's vast integration experience and may bring technologies and best

practices that differ from those acquired through the FTAA.

It is also important for Latin America to strengthen trade and investment links with Asia. Asia's recent movement toward regional integration may help open the door for bilateral agreements with this region.

THE SUBREGIONAL FRONT

The FTAA will force countries to rethink the role of subregional integration agreements. Most governments in the hemisphere realize that agreements that are less comprehensive than the FTAA will be absorbed by it. But would current subregional agreements, most of which consist of imperfect and incomplete customs unions, be worth keeping in their current forms?

The answer is, probably not. The very fact that these customs unions are incomplete negates one of their principal advantages over free trade agreements—the elimination of rules of origin and other administrative burdens at the border. Moreover, the common practice by customs union members in the region of negotiating unilaterally with third parties erodes the potential advantages of negotiating as a bloc. Subregional trade agreements looking to preserve a vehicle for group cooperation should complete the customs union, thus fully capturing its potential benefits, or fall back to a free trade agreement, provided that it is more comprehensive than the FTAA.

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An Agenda for the Future

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For those subregional trade agreements worth deepening, what is next on the agenda? What are the priorities? How can countries strengthen agreements they already have?

- ♦ *Complete customs unions projects*, beginning with full implementation of the common external tariff (CET). Exceptions to free trade within the agreement should be phased out and other non-tariff barriers removed. Once agreement has been reached on the CET, bilateral deals with third parties by individual members should be discouraged. Modernizing and simplifying customs procedures would also save valuable time at border crossings.

- ♦ *Develop regional infrastructure* to facilitate the movement of goods and people across borders. After all, cross-border activity drives integration and is thus a key to success in deepening subregional integration.

- ♦ *Strengthen the institutional framework* to deepen subregional integration. One fundamental need is transparent and modern dispute settlement mechanisms. Other institutional demands range from mechanisms for common customs collection and distribution to agencies that can certify mutually recognized technical standards and other regulations, anti-trust policy and different forums for policy coordination. One institutional area of particular importance is member government support and oversight of a career-oriented and professional Technical Secretariat.

- ♦ *Advance toward macroeconomic coordination* to reduce the

crises and large exchange rate swings that may stress the relationship among partners and erode political support for integration. Macro coordination has its costs, however, as it may mean sacrificing some of the government's discretion on fiscal or monetary policy. So what should countries do? The alternatives range from doing nothing—which would sound the death knell for some subregional agreements—to creating a monetary union, for which most integration agreements in the region do not appear to be good candidates at this point. An intermediate option could be to try to limit exchange rate volatility, perhaps as a first step on the road toward a monetary union.

- ♦ *Maximize the opportunity to attract more FDI*. Countries and subregions should strive to improve their institutions, in particular those that enforce the rule of law, and reduce excessive regulation. Assuring that multinationals receive the same treatment as national firms and that educational systems produce qualified workers are other important elements to attract FDI. These measures are preferable to costly incentive wars that can shift the distribution of benefits from host countries in favor of the firm.

- ♦ *Enhance the productivity and competitiveness gains* that trade and investment can bring. In this area, partnering with industrialized countries appears to be the key. Complementary domestic policies to enhance productivity include strengthening credit and labor markets, upgrading institutions to create an enabling environment for firms, improving

education and infrastructure, and establishing policies that allow firms to take advantage of information technologies.

- ♦ *Protect the losers in the integration process* with policies such as training and job search programs, unemployment insurance, workfare programs, social safety nets available to everyone in poverty, and improvements in education.

MULTILATERAL LIBERALIZATION AND THE DOHA AGENDA

The link between successful regionalism and a healthy multilateral system is fundamental. First, progress in Geneva on certain key negotiation topics, such as agriculture or anti-dumping, could condition progress in similar topics in the FTAA negotiations and talks with the EU and East Asian countries. Second, the Doha Development Agenda includes negotiations regarding regional rules, which regulate the link between regionalism and the multilateral system, and which have ample room for improvement. These negotiations should clarify issues such as restrictions on the formation and implementation of common external tariffs, preferential rules of origin in RIAs, and mechanisms to encourage compliance with the agreed-upon timetables for commitments to such agreements. The bottom line is that success in the Doha Agenda is not only strategically critical for Latin America, but also a key to ensuring continued progress toward a system of open regionalism, one that constitutes a building block, not a stumbling block, for global free trade.

Regional Integration and Productivity: A Tale of Two Countries

(continued from page 6)

exporting gains on Mercosur trade, but these gains do not appear to have been any different from those from exports to the rest of the world.

Considering the limits of Mercosur gains, the importance of the import-discipline effect and the fact that productivity growth only took off in the second half of the 1990s, it is tempting to believe that Brazil would have performed better with a more aggressive approach towards integration, one that would not have excluded

Mercosur, but that would have gone beyond it, in search of more sizable trade gains.

The bottom line seems to be that both Brazil and Mexico reaped important productivity gains from integration. How much of these gains were a one-time productivity surge and how much provided fuel for sustained growth? Will this “integration shock” produce the same sort of rapid, sustainable and long-term productivity growth seen in East Asia? Perhaps it is too early to

tell. Likely it will depend very much on the long-term effects of import discipline on the countries’ rate of innovation. In any case, it is unrealistic to expect integration to do the entire job. When it comes to a stable macroeconomic environment and investment in education, technological capabilities and institutions—all key ingredients of productivity growth—both countries, not to mention the whole region, still lag behind their counterparts in East Asia.



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