

Asymmetries and Cooperation in the Free Trade Area of the Americas

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ABSTRACT

In 1994, Latin American and Caribbean countries (except Cuba) embarked with Canada and the United States in the construction of the Free Trade Area of the Americas (FTAA). The FTAA would be the largest free trade area in the world with a combined population of 800 million and a gross domestic product (GDP) of about US\$ 11 trillion. It is, indeed, an ambitious project and a formidable challenge given the wide asymmetries in size and economic development of the participating countries.

A confluence of different factors, including developments in global markets, country specific conditions, and economic policies, will have a bearing on the extent to which countries will benefit from hemispheric trade liberalization. This paper argues that the way asymmetries are addressed will have an effect on the capacity of countries, particularly the smaller and less developed, to benefit from expanded trade opportunities. In particular, it claims that it will be important for development that member countries preserve margins of flexibility in FTAA disciplines to adopt active productive development policies to improve competitiveness, and to manage the capital account. Furthermore, it argues that convergence of development levels among the countries of the hemisphere may require new ambitious initiatives, particularly the design of cohesion/integration funds and increased labor mobility. Alongside the FTAA agreement, hemispheric cooperation on these topics will effectively help strike a balance among countries of such wide disparities in size and level of development.

Section I looks at the FTAA in the context of current trade policies and agreements. Section II analyses the treatment of asymmetries in trade agreements and suggests that the current practice of dealing with asymmetries might impose serious constraints to developing countries. Section III addresses the importance of preserving autonomy to foster productive development and manage capital flows. Section IV examines prospects for income convergence and highlights the experience of Puerto Rico in the post-war period. Section V suggests areas where cooperation could be broadened.

1. THE CONTEXT FOR THE FTAA

In an effort to meet the challenges posed by globalization, Latin American and Caribbean countries opened up their trade regime and sought to redefine their linkages with the global economy since the mid-1980s (before in a few countries). The steps taken to open up to trade were swift and extensive. Alongside unilateral liberalization, integration processes were encouraged and a large set of free trade agreements was signed. ECLAC characterized this trade policy mix as “open regionalism” (ECLAC, 1994).²

Close ties were also sought with countries outside the region, mainly with the United States, Canada and the European Union.³ The first of these agreements, the North American Free Trade Agreement (NAFTA), was the first reciprocal agreement between developing and developed countries. Mexico, which previously was a beneficiary of the Generalized System of Preferences (GSP) of the United States and Canada, entered into an agreement characterized by similar obligations to that of the developed countries. Many of the agreements after NAFTA have, to some extent, followed a similar model in terms of structure, scope and treatment of asymmetries.

NAFTA marked a turning point in economic relations between Latin American and Caribbean countries and the United States and set a precedent for the negotiations toward a hemispheric-wide free trade area. Two years after NAFTA was signed, in 1994, the process to construct the FTAA was launched in the context of the Summit of the Americas, a broader social and political process among 34 countries in the Western Hemisphere.

Improved market access, with the United States market as the main attraction, is one of the potential gains from hemispheric trade liberalization. The relative importance of the United States market in terms of each country’s foreign trade activity varies widely throughout the region. However, even in countries where trade with the United States is relatively less important, this market may constitute an important destination for some manufactures, and improved access would provide an opportunity for export

² The rebirth of integration in the region, marked by the creation of the Southern Common Market (Mercosur) in 1991, was accompanied by new impetus in the region’s older subregional agreements, the Central American Common Market (CACM), the Andean Community (CAN), and the Caribbean Community and Common Market (CARICOM) and by a proliferation of bilateral free trade agreements.

³ The shift in United States’ trade policy from multilateralism to a multilevel approach that took place in 1985 when President Reagan instructed trade negotiators to explore regional and bilateral agreements was key to the reemergence of regional initiatives worldwide.

diversification. On the other hand, in agriculture, elimination of barriers to market access and export subsidies, together with reduced domestic support, are expected to provide gains for participating countries.⁴

For countries that are beneficiaries of U.S. unilateral preferences, participation in the FTAA means reducing uncertainty --i.e., an insurance against discretion in the granting of preferences.⁵ The cost of this insurance is, obviously, reduced protection and policy autonomy. Irrespective of securing market access, remaining outside a hemispheric-wide free trade area does not appear a viable alternative, particularly for the smaller economies, if access to the largest market in the hemisphere is to be preserved. This is especially the case for countries in the Caribbean Basin who lost market share and investment on account of Mexico's gaining access to the U.S. market through NAFTA. Moreover, participation in FTAA negotiations is one of the eligibility criteria that countries desiring to benefit from existing preferential schemes must comply with.

Beyond the traditional incentives of securing access and expanding exports, the FTAA could be functional for the attraction of foreign investment. This could be particularly important for smaller economies willing to participate more actively in international outsourcing. Moreover, the FTAA represents an opportunity to discipline the use of contingent protection measures, such as antidumping and countervailing duties, which create unjustified barriers. The application of the trade remedies has affected important exports from the region --steel from Brazil and Argentina, flowers from Colombia, grapes and salmon from Chile, crude oil and steel from Venezuela, among others (Table 1).

⁴ See, for example, Monteagudo and Watanaki (2002).

⁵ U.S. unilateral preference schemes include the Caribbean Basin Economic Recovery Act (CBERA) of 1983, the Andean Trade Preference Act (ATPA) of 1991 and, more recently, the Caribbean Basin Trade Partnership Act (CBTPA) of 2000.

**Table 1: Anti-dumping Investigations Initiated by the U.S.
1980 – 2001**

Country	Anti-Dumping investigations Initiated			Anti-dumping orders issued			Percent Restrictive		
	1980-1989	1990-2001	Total	1980-1989	1990-2001	Total	1980-1989	1990-2001	Total
All Countries	383	527	910	174	225	399	45%	43%	44%
Latin America & The Caribbean	59	82	141	22	26	48	37%	32%	34%
Argentina	6	11	17	3	5	8	50%	45%	47%
Brazil	24	22	46	10	10	20	42%	45%	43%
Chile	2	5	7	2	2	4	100%	40%	57%
Colombia	4	1	5	1	0	1	25%	0%	20%
Costa Rica	1	4	5	0	0	0	0%	0%	0%
Ecuador	1	1	2	1	0	1	100%	0%	50%
El Salvador	1	0	1	0	0	0	0%	0%	0%
México	8	23	31	2	7	9	25%	30%	29%
Peru	1	0	1	0	0	0	0%	0%	0%
Trinidad & Tobago	1	3	4	1	0	1	100%	0%	25%
Venezuela	10	12	22	2	2	4	20%	17%	18%

Source: ECLAC based on U.S. Dept of Commerce, International Trade Administration, July 2002.

2. FROM SPECIAL AND DIFFERENTIAL TREATMENT TO A “LEVEL PLAYING FIELD”

The scope of the FTAA is broad, reflecting the consensus to negotiate a wide and diverse range of issues seeking to expand and deepen reciprocal commitments into new areas beyond the reduction of tariff and other border barriers. Its agenda includes the traditional market access disciplines for trade in goods as well as new issues such as services and intellectual property, including areas --competition policy and investment-- that have not been the subject of multilateral negotiations in the World Trade Organization (WTO). It also seeks to improve WTO rules and disciplines wherever possible and appropriate.

Moreover, the FTAA is set to constitute a single undertaking of mutual rights and obligations. It will be a reciprocal agreement such that all countries, regardless of size and level of development, will ultimately have to assume the full set of obligations. Similarly, in the Canada-Chile, as well as Mexico-European Union and Mexico-EFTA free trade agreements, among others, trade relations are governed by reciprocity. Differences in size and level of development, which as shown in Table 2 are several times larger than those characteristics of the European Union, are expected to be addressed through technical cooperation programs and longer periods for compliance with obligations, among other possible alternatives.

As in NAFTA, treatment of asymmetries will be a result of the negotiation process. The transitional measures included in the NAFTA, which allow for differential treatment were, indeed, the result of the negotiating process and not an a priori concession granted to Mexico on account of its level of development. This, as well as other recent trade agreements between developed and developing countries have tended to address asymmetries through specific, transitory and negotiated provisions, rather than through exemptions to general rules and disciplines, allowing in particular more flexibility and time for the implementation of commitments. In the Canada-Costa Rica agreement, for example, asymmetries were reflected in differences in tariff elimination schedules and in more flexibility in the enforcement of rules of origin for a few products. Technical cooperation programs were also provided in the area of trade facilitation and of technical barriers to trade.

Table 2
Disparities in levels of development and size

A. GDP per capita (constant 1995 US\$)			
	1960	1980	1999
Coefficient of variation			
European Union (EU)	0.46	0.36	0.37
EU and candidates	0.52	0.65	0.78
FTAA	1.16	1.16	1.26
Highest / Lowest			
EU	5.95	3.70	4.28
EU and candidates	10.76	20.55	41.49
FTAA	25.9	34.6	83.2
B. GDP per capita, PPP (current international \$)			
	1960	1980	1999
Coefficient of variation			
European Union (EU)		0.22	0.26
EU and candidates		0.38	0.49
FTAA		0.79	0.85
Highest / Lowest			
EU		1.95	2.77
EU and candidates		4.54	8.43
FTAA		9.02	21.8
C. Population, total			
	1960	1980	1999
Coefficient of variation			
European Union (EU)	1.09	1.07	1.07
EU and candidates	1.19	1.16	1.18
FTAA	2.81	2.55	2.42
Highest / Lowest			
EU	230.78	214.59	190.05
EU and candidates	230.78	214.59	190.05
FTAA	3,542.55	5,117.57	6,806.0

Source: ECLAC estimates based on World Bank, World Development Indicators (2001)

The current way of dealing with asymmetries is a result of a shift in thinking on development and trade policies. Furthermore, the emphasis on transitional time frames and on the provision of technical assistance has tended to narrow down alternatives, relative to how this issue has been dealt with in other negotiation processes.⁶ Up to about the mid 1980s, the prevailing belief was that the dynamics of development were different in developing countries. In particular, patterns of economic specialization -- the high level of dependence on commodities with low-income elasticity of demand— and the associated balance of payments vulnerabilities, were viewed as obstacles to income convergence.⁷ Overcoming asymmetries required both changes in the international economic order as well as efforts at promoting industrialization through import substitution and export promotion. In the multilateral trading system these changes translated into demands for preferential access by developing countries to developed countries markets, flexibility in the application of disciplines and, more broadly, non-reciprocal trade

⁶ Differential treatment within trade arrangements to address asymmetries in levels of development and size has traditionally included five types of provisions: time-limited derogations from obligations and longer periods for implementing obligations; more favorable thresholds for undertaking certain commitments; flexibility in obligations and procedures; other commitments and best endeavor clauses; and technical assistance and advice. See UNCTAD (1994)

relations between developed and developing countries. The asymmetrical treatment of developing countries was applied through exemptions to general rules and disciplines in a form that would allow for the protection of markets and subsidies to industries in order to strengthen and diversify the industrial base. Policy discretion included the right to maintain trade barriers to deal with balance of payment problems and to protect infant industries using industrial and trade policy measures that otherwise would be inconsistent with multilateral obligations (Gibbs, 1998). At the same time, more favorable and non-reciprocal access to markets in developed countries was granted through GSP and other preferential schemes determined unilaterally by developed countries.⁸

Since the mid-1980s, the emphasis on unilateral liberalization led to revisit the way asymmetries had to be dealt with and the usefulness of differential treatment as it had been conceived. The concept changed from a focus on preferential access and differential provisions to an emphasis on the difficulties faced by developing countries in the implementation of WTO commitments. An alternative paradigm emerged whereby the basic objective of trade relations was to provide a “level playing field” for the efficient operation of free market forces.

The practice of leveling the playing has led to the adoption of common obligations (rules and disciplines). The Canada-U.S. Free Trade Agreement (CUSFTA), for instance, has been interpreted as a series of concessions made by Canada, the smaller partner, in exchange for assurances against future trade policy by the larger partner (McLaren, 1997). Whalley (1996) suggests a similar conclusion regarding Mexico in the negotiations leading to NAFTA. Mexico’s objective of strengthening domestic policy reform via importing common rules and disciplines would explain the one-sidedness of the concessions.

The adoption of common FTAA rules and disciplines is not in itself undesirable as the experience of Mexico would suggest (López Cordova, 2001). However, significant tradeoffs may emerge. As we will see in Section III, conflicts may result from further liberalization of investment and, particularly, by the lack of adequate instruments to manage capital account volatility. As the experience of the region in the 1990s suggests, the flexibility to impose restrictions on capital flows to facilitate the adoption of counter-cyclical macroeconomic policies may be necessary to reduce the vulnerability of the countries to cyclical swings in external financing. A level playing field approach imposing similar obligations would generate, in this case, a false equality. Thus, the greater macroeconomic vulnerability of the countries of the region

⁷ See, for instance, Ocampo (2001), Whalley (1999).

⁸ The latter include those schemes mentioned in footnote 3, as well as the Lomé (now Cotonou) Convention, among others.

to external shocks underscores the need of striking a balance between these competing interests in the negotiations.

The practice of leveling the playing field may also worsen asymmetries. If agreed rules eliminate the autonomy to adopt active production development strategies, they would weaken the linkages between export and GDP growth and may lead countries to specialize in sectors of reduced dynamism in world trade. This would be the case if constraints were imposed on policies that foster innovation, technological development, and strengthen the export base. Also, intellectual property disciplines such as provisions related to patent protection could increase the costs of foreign technologies, inhibit development of new technologies, slow down national learning processes, and the narrowing of the technological gap with the more advanced economies.⁹ In contrast to patenting trends in developed economies and in the newly industrialized countries in South-East Asia, the number of patents applied for by non-residents in Latin America is growing much faster than those requested by residents. This trend is related to the use of patents by foreign corporations, which in some cases could hinder the development of local production and technological capabilities (Aboites and Cimoli, 2001).

Thus, unless asymmetries are properly accounted for, common rules may end up limiting the promotion of new comparative advantages which, as will be argued below, is of vital importance to the countries of Latin America and the Caribbean in order to strengthen the relationship between exports and economic growth.

⁹ See, Primo Braga *et al.* (2000). Moreover, as in the experience of Argentina with TRIPS implementation, while there is no guarantee that benefits will be secured, the costs can be quite high. Nogués (1993) estimated that the transfer from Argentine consumers to foreign producers would be about \$425 million per year (17% of the value of patented pharmaceuticals sold in Argentina in 1999).

3. AUTONOMY TO FOSTER PRODUCTIVE DEVELOPMENT AND MANAGE VOLATILITY

The outcome of the reallocation of production and consumption patterns that hemispheric trade liberalization is expected to bring about will depend on the final nature of the agreement --depth and scope of disciplines—but also on a confluence of factors. Among the latter, the capacity of countries to promote competitiveness and to manage capital account volatility will have an effect on the extent to which countries will benefit from hemispheric trade liberalization.

In the case of the smaller economies of the region, their size and vulnerability pose additional constraints. Recent developments in both trade and growth theories suggest that trade among asymmetric countries may also lead to an increase in income gaps, as technological advantages may be cumulative (Ros, 2000; ECLAC, 2000, ch.11).¹⁰

1. Export and production linkages¹¹

Despite overall advances in some countries, opening up the economy is not a sufficient condition to improving the region's growth performance. During the nineties, Latin America and the Caribbean had one of the world's highest rates for merchandise trade in terms of both volume and value. The average annual increase in merchandise exports amounted to 8.4% in volume --a rate surpassed only by China and a few of the Asian economies. However, the dynamism of exports was not reflected in behavior of the economy; the region's strong export performance had weak returns in terms of economic growth (see Figure 1). The average annual rate of economic growth of the region since 1990 of 2.6%, was less than one third of the growth in real exports.

¹⁰ By contrast, neoclassical trade theory postulates that when a small country liberalizes trade with a large one, the gains flow disproportionately to the former since the small country will undergo relatively larger changes in its price structure and obtain greater gains on account of the reallocation of production and consumption.

¹¹ This section draws from ECLAC (2002a)

Figure 1
Exports and GDP



This outcome can be read, first of all, as the net result of the opposing effects on aggregate demand of export growth and a sharp increase in the import coefficient, associated with a reduction in levels of protection, the tendency towards a revaluation of the exchange rate, and the high import content of inputs in many of the robust export industries, especially in the manufacturing sector (Moreno-Brid, 2002). On the other hand, static comparative advantages led the economies to specialize in sectors of reduced dynamism in world trade. In structural terms, although import penetration did contribute to the modernization of production and to new exports based on the increased incorporation of imported inputs, it also weakened the linkages between exports and overall economic activity.

The region' share of international trade rose from 4.5% to 5.5% during the decade, largely concentrated in Mexico. Overall, though, this increase was to a large extent the result of competitiveness gains in slow-growth products than of gains in more dynamic trade flows. Thus, an assessment of the region's export specialization during the last decade, measured in terms of the relative weight of high-demand products in the export basket, reveals that its quality was quite poor (Table 3).

Table 3
LATIN AMERICA AND THE CARIBBEAN: CHANGES IN MARKET SHARES AND
RELATIVE SPECIALIZATION INDEX FOR HIGH-DEMAND PRODUCTS

	Market Share (%)				Relative specialization index for high-growth products a/		
	1990	1993	1996	1999	1990-1993	1993-1996	1996-1999
Mexico	1.292	1.446	1.911	2.441	0.515	0.844	0.679
Mercosur^b	1.552	1.528	1.545	1.499	0.645	0.828	0.655
Andean Community	0.888	0.822	0.913	0.822	0.298	0.622	0.369
CACM^c	0.190	0.230	0.274	0.350	1.550	0.975	1.323
CARICOM^d	0.182	0.163	0.145	0.131	0.787	0.711	0.348

Source: ECLAC, on the basis of data obtained from the Competitive Analysis of Nations Program (2002 version).

a/ Ratio of exports of high-growth products to exports of low-growth

b/ Southern Common Market

c/ Central American Common Market

d/ CARICOM Community

Three patterns of specialization have prevailed. In Mexico and some countries of Central American and the Caribbean, export specialization can be characterized by integration into vertical flows of trade in manufactures mainly centered in the United States market. This pattern of specialization allowed these countries to benefit from some dynamic manufacturing markets --and, curiously, more so in the case of the Central American markets than Mexico, as Table 3 indicates--, but at the cost of reduced domestic linkages, given the high import content of such manufactures (maquila in the extreme case).

A second pattern, which prevailed in South America, is specialization in horizontal production and marketing networks, mainly of raw materials and natural resource-based manufactures. This pattern allowed more domestic linkages (including technological developments) but generally led countries to specialize in goods that are losing share in world trade; the latter feature was particularly problematic in the case of the Andean countries (see again, Table 3). Interestingly, intraregional trade was a major element in South American trade during the 1990-1997 expansion, providing a large content in manufactures with domestic linkages, but such flows were significantly affected by the broad-based slowdown that affected the region since the Asian crisis.

Finally, countries in the Caribbean and Panama reveal a third pattern with high predominance of export of services, for the most part tourism, but also financial and transportation services. The most important of all, tourism, is a dynamic component of world trade, but has also been characterized by high import contents, particularly in the smaller economies.

The export performance of Latin America and the Caribbean in the 1990s thus suggests that strong export-GDP growth linkages and improved competitiveness, particularly in dynamic segments of world trade, are not automatic outcomes of greater openness. This implies that unless countries engage in a coherent effort to stimulate the linkages between export sectors and domestic economic activities, thus increasing the value added (i.e., GDP) of exports, as well as to encourage dynamic, knowledge-based comparative advantages, export-GDP linkages would be weak and exports would tend to be concentrated in products for which demand is less dynamic and more vulnerable in world trade.

In this regard, valuable lessons can also be drawn from the experience of the East Asian economies. Recent research has noted that an important part of the success of the East Asian countries' integration into global trade flows rested on discretion to use a variety of policy measures and incentives targeted at specific sectors and industries which were successful in building competitive export supply capacities. Strategic integration was not only confined to trade but also included policies that promoted technology transfer.¹² One important lesson from the East Asian experience is that while a deliberate and active approach to integration through measured and properly sequenced set of policies towards trade and investment cannot guarantee economic success, success without it seems to be the exception rather than the rule.

For Latin American and Caribbean countries, active participation in a hemispheric market requires speeding the rate of innovation, including the transfer of technology, develop new production sectors and support learning processes. This entails devising strategies to promote new firms and activities, restructure sectors that are not competitive, and support for small and medium-sized enterprise to help strengthen the ties between exports and productive sectors and thus participate in new trade flows on a competitive basis. Building competitive export supply capacities demands creating linkages between activities that are successful in international markets and the rest of the production system. A stronger export orientation, particularly based on the promotion of exports that are knowledge intensive or involve a high level of value added, is crucial for export capacity to translate into greater economic growth.

Although WTO disciplines (and the FTAA seeks to be WTO+) have reduced the scope for using the more generalized policy interventions of the East Asian approach, a strategy of this type will require flexibility in the way countries commit to common FTAA obligations. In particular, it is necessary to preserve margins of autonomy in the FTAA for adopting open economy-oriented policies to improve competitiveness. This includes intellectual property schemes that promote the transfer of technology, the

use of incentives to support the diversification of the export supply and mechanisms to increase the national content of exports.

2. External vulnerability

Policy autonomy is essential as well in the use of instruments to manage external shocks. In this regard, exchange rate policy should not be subject to restrictions --though macroeconomic convergence schemes in subregional agreements should be allowed-- and autonomy should also be maintained to use capital account restrictions for macroeconomic purposes, particularly to reduce capital account volatility.

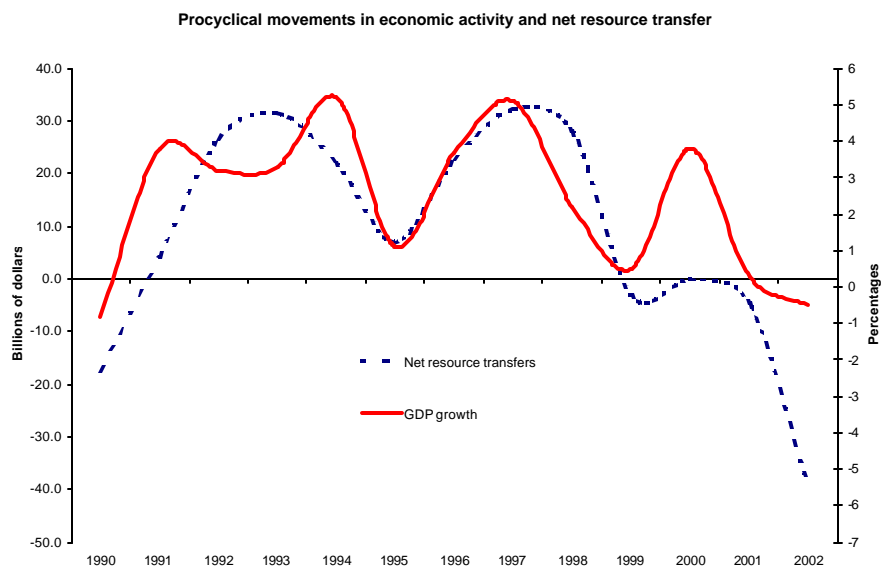
A competitive real exchange rate and real macroeconomic stability are essential for hemispheric trade liberalization to be successful and contribute to an efficient allocation of resources. To stimulate the production of tradables, a favorable and stable real effective exchange rate must be maintained, i.e., an exchange rate that fluctuates on the basis of long-term factors and is not overly correlated with short term capital movements.

Developments in the 1990s underscore the difficulties that Latin American countries found in maintaining a competitive exchange rate consistent with their commitment to trade liberalization, in a situation marked by sizeable and volatile capital flows. The vulnerability of the region to cyclical swings in external financing thus proved to be a particularly serious constraint to sustainable trade flows.

As Figure 2 shows, the growth pattern of Latin America and the Caribbean during nineties was very unstable and highly dependent on external flows. Variations in capital flows were the main factor behind the pronounced business cycles. Severe slowdowns or outright recession followed brief periods of economic growth. External credit booms facilitated rapid growth in 1991-1994 and 1996-1997, and a recovery in 2000, but these periods were followed by deep adjustments in 1995, 1998-1999 and 2001-2002. The result was unstable and mediocre regional growth averaging 2.6% between 1990 and 2002.

¹² See, Amsden (2001), Akyüz et al.(1998), Chang (2001).

Figure 2



Countries' reliance on highly volatile financing flows, in particular short-term credit lines and portfolio flows, was a key element behind vulnerability to fluctuations in external financing. The impact of sharp swings in international financing was accentuated by a procyclical pattern of macroeconomic management. Upsurges in capital inflows were accompanied by excessive domestic credit, liquidity expansion, and appreciation of the exchange rate that led to deterioration in the current account of the balance of payments. When external capital inflows were reversed, liquidity contracted, a fear of depreciation accelerated the loss of reserves, and a severe adjustment in the current account. Booms in external financing, which occurred against a backdrop of financial liberalization and weak prudential regulation and supervision, ended up in domestic financial crises.

Dealing with the destabilizing effects of the boom-and-bust cycles in volatile capital flows requires a comprehensive strategy for growth with stability. In this regard, macroeconomic stability should thus be viewed in a broad sense that includes, in addition to the control of the fiscal deficit and reduction of inflation, real goals in terms of economic growth and its stability. As ECLAC has proposed, such a strategy should be founded upon action in three areas: strengthening the international financial system's ability to prevent and manage crises and the countries' capabilities for designing preventive macroeconomic policies; speeding the pace of export development and improvements in the region's access to international financial markets; and increasing national saving and promoting domestic financial development so that available resources can be increased and adequately channeled into investment (ECLAC, 2002b).

Within the above, it is essential to design policies that protect from crises and that are consistent with the realities of developing countries. In this vein, capital account regulations are important complementary tools of well-designed macroeconomic policies, providing additional degrees of freedom to avoid excessive borrowing, and help avoid as well an unsustainable appreciation of the exchange rate. The capital-account regulation mechanisms adopted by Chile and Colombia in the 1990s represent successful experiences in managing foreign account surges through unremunerated reserve requirements on capital inflows.¹³

Therefore, preserving autonomy within the FTAA in the use of tools for the prudential management of capital flows is essential to confront the impact of destabilizing crisis and disruptions of trade flows.

3. Size and vulnerability

The smaller economies of the region face additional constraints. Smallness has disadvantages.¹⁴ It inhibits economies of scale and scope leading to higher production costs and unfavorable competitive positions. These disadvantages affect both the public and private sectors. For instance, the cost of public services per capita is usually higher in smaller economies than in larger ones since most public goods and infrastructure services are characterized by their indivisibility. Activities in the private sector face similar difficulties since economies of scale and externalities cannot be achieved adequately due to the small size of the domestic market.

Though higher direct unit costs affect the tradable sector, they are especially critical in non-tradable sectors. In the production of tradables, foreign markets offer the opportunity to exploit economies of scale and scope, though at the cost of further specializing in a narrow range of sectors and products, thus increasing vulnerability (see below). However, scale economies are critical in non-tradable sectors, for which the market is, by definition, domestic. To the extent that non-tradable goods and services are inputs for the production in tradable sectors (including activities such as domestic financing and marketing services), the absence of economies of scale in the production of the former will spill over into the competitiveness of the latter (ECLAC, 2000).

In addition to these constraints, smaller countries are more vulnerable than the larger economies in the sense of being more prone to external shocks. Vulnerability is associated with geographic (country size

¹³ For an analysis of capital surge management in Chile and Colombia, see, Ffrench-Davis and Tapia (2001), Ocampo (2003), and Ocampo and Tovar (1998, 1999).

¹⁴ On the other hand, smallness is also associated with advantages, for example, that of greater social cohesion. Ocampo (2002) explores the advantages and disadvantages of size focusing on the Caribbean economies.

and its location), demographic, and economic factors resulting in smaller economies being more prone to risks. Exports from the smaller countries tend to be highly concentrated in a narrow range of products and markets. The economies are more exposed to external shocks in prices and quantities and tend to suffer from higher terms-of-trade volatility than larger countries, thus increasing any costs of adjustment associated with trade liberalization. At the same time, their macroeconomic policy autonomy is more limited, in particular the ability to change relative prices through exchange rate policy and to smooth out business cycles through an autonomous interest rate policy.

Moreover, the greater fiscal dependence on foreign trade of several of the region's smaller economies compounds the burdens of adjustment associated with the loss of income from FTAA tariff reductions. In some countries (Bahamas, Dominica, Grenada, St. Kitts & Nevis, and St. Lucia), international trade taxes account for more than 50% of government revenue (Escaith and Inoue, 2001). In addition, the lost revenue will potentially be more problematic for those countries that, in addition to being dependent on trade taxes, face a relatively large fiscal deficit, as shown in Table 4.

Table 4
Latin America and the Caribbean: Fiscal balance and dependency on trade taxes
 (1995-1999 averages)

DEPENDENCY ON TRADE REVENUES	SURPLUS OR SMALL DEFICIT	MODERATE DEFICIT	LARGE DEFICIT
LOW	Trinidad & Tobago	El Salvador Mexico	Bolivia Brazil Costa Rica Uruguay
		Chile	Ecuador Guyana
MODERATE		Argentina Barbados Guatemala Panama Paraguay Peru	
HIGH	Dominican Republic	Netherlands Antilles St. Kitts & Nevis St. Lucia St. Vincent & the Grenadines Venezuela	Antigua & Barbuda Bahamas Belize Colombia Dominica Grenada Haiti Honduras Nicaragua Jamaica

Source: Hubert Escaith and Keiji Inoue (2001), *Small Economies' Tariff And Subsidy Policies In The Face Of Trade Liberalisation In The Americas*.

Note: Deficit levels are strictly for comparison purposes and do not necessarily imply fiscal fragility. These were determined by the average deficits during the period between 1995 and 1999. Countries at the upper end of the sample had average deficits of over 2% of GDP (and/or have had volatile changes in their deficits); a middle group had deficits between 1 and 2% of GDP and another group had surpluses or deficits of less than 1%.

There appears to be broad agreement on the constraints faced by the smaller economies of the region to benefit from the process of hemispheric liberalization and on the need for technical cooperation and capacity building (VII FTAA Trade Ministerial, Quito, Ecuador, November 2002).

However, more longer-term advantages in terms of room of maneuver to adopt strategies to improve competitiveness are required. Moreover, as the next section will highlight, free trade, even with special provisions, may be insufficient to promote convergence.

4. TRADE LIBERALIZATION AND CONVERGENCE

Will the FTAA, which involves large asymmetries in terms of size and levels of development of member countries, be a force for between-country income convergence among participating countries? Empirical work on trade liberalization and income convergence give ambiguous answers to this question. While some studies suggest that trade liberalization plays a key role or that even it may be sufficient for income convergence, others emphasize the role played by non-trade factors. The study by Barro and Sala-i-Martin (1991) would suggest that among regions that are open to each other, the poorer would grow faster than average. The authors find that in the case of states of the United States and regions of Europe, poorer regions converged to richer ones at a pace of about 2% between 1960 and 1985. The authors maintain that convergence does indeed occur, though at a slow pace. In turn, Ben-David (1993, 1996) finds that the removal of trade barriers among the main European Economic Community countries was followed by significant income convergence. Convergence, while far from being a worldwide phenomenon, seems to prevail among countries that trade extensively with one another.

Rodríguez and Rodrik (2001), and Slaughter (2001) have challenged the empirical evidence on several grounds, including issues related to the measurement of openness and the time period of analysis, and have thus questioned the empirical results that trade liberalization necessarily leads to faster convergence. Even if convergence occurs, many factors other than trade --common laws and institutions, labor mobility, and income transfers-- are potentially at play.

In our hemisphere, this is best illustrated by the case of Puerto Rico. Indeed, Puerto Rico's development experience in the postwar period serves to illustrate the links

Table 5
Average Annual Growth
of Real GDP Per Capita

1950-1960	5.3
1960-1970	6.4
1970-1980	2.6
1980-1990	2.6
1990-2000	3.3
1950-2000	4.

Source: ECLAC on the basis of Puerto Rico National Accounts and Baumol and Wolf (1996)

Table 6:
Exports as a % of GDP

1950	33.7%
1960	37.2%
1970	34.8%
1980	56.8%
1990	67.5%
2000	65.7%

Source: Puerto Rico Planning Board.

between trade openness and income convergence, but also the effects of other factors that accompanied trade liberalization, particularly industrial incentives, transfer payments, and labor mobility.

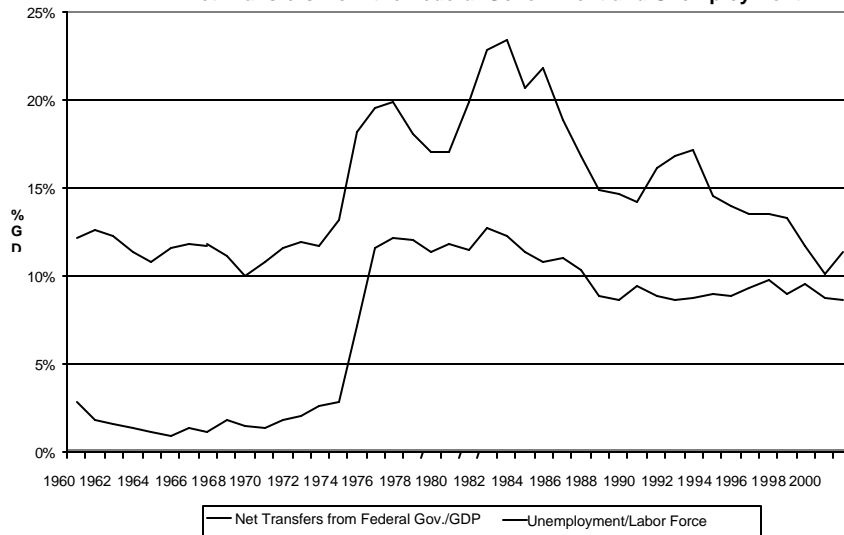
Puerto Rico's development strategy initiated in the 1940s, Operation Bootstrap, yielded robust growth by attracting U.S. investment and transforming Puerto Rico's agricultural base into an economy led by manufacturing and services. In the 1950s and 1960s, the average annual growth of Puerto Rico's real GDP per capita was 5.3% and 6.4%, respectively. The gap between income per person in the U.S. and Puerto Rico declined rapidly, from a factor of nearly six in 1950 to a factor of four in 1960, and 2.7 in 1970 (Dietz, 2001). After 1970 the relative gap between incomes in the two economies failed to converge any further. In the 1990s the income gap started to close again, although at a very slow pace, declining to a factor of two in 2001.

The main ingredient of Puerto Rico's Bootstrap strategy was the attraction of U.S. capital for investment purposes in industries oriented towards exports to the U.S. market, within a virtually tax-free environment. Labor mobility, with unrestricted out-migration to the U.S., and a large positive inflow of transfer payments from the U.S. were two key factors that supported this strategy.

The package of incentives included industrial tax exemptions and other incentives under both Puerto Rican and U.S. laws. From the beginning of Operation Bootstrap up to the Industrial Incentive Act of 1978, Puerto Rico offered full tax exemption from local taxes and other fees, and provided also a variety of subsidies on rent and labor costs. In addition to these incentives, exemption from U.S. corporate income taxes was granted to firms (qualifying U.S. "possessions corporations") operating in Puerto Rico. Under Section 936 of the U.S. Internal Revenue Code (Section 931 until 1976), U.S. corporations obtained tax credits against federal taxes attributable to the income earned from business operations and certain financial investments in Puerto Rico. Section 936 stimulated investment, for the most part mainland capital for export.

Puerto Rico's industrial incentives and Section 936 shaped the manufacturing sector, which grew and shifted from labor to capital-intensive manufacturing industries. The "936 corporations", as they were called, came to dominate Puerto Rico's manufacturing sector, whose share of total output increased from 22% in 1950 to 39% in 1990, with Puerto Rico ranking above all 50 states of the mainland in

Figure 3
Puerto Rico
Net Transfers from the Federal Government and Unemployment



Source: ECLAC on the basis of data from Puerto Rico's Planning Board.

manufacturing's share of gross domestic product. Manufacturing was the leading force in Puerto Rico's growth of trade, particularly exports of chemical products such as drugs and pharmaceutical.¹⁵

On the other hand, Figures 3 and 4 illustrate the important counter-cyclical role played by federal transfers in Puerto Rico's economy, in particular since the 1970s, following the slowdown in economic growth in Puerto Rico that left the income gap between the U.S. and Puerto Rico unchanged from 1970 to 1990. Federal transfers --which have represented since the mid-1970s close to 10% of Puerto Rico's GDP-- are strongly correlated with the business cycle.¹⁶ As shown in Figure 3, there is a strong positive correlation between federal transfers and unemployment, thus indicating the counter-cyclical nature of federal transfers.

Moreover, the net flow of official transfers compensated for the low saving rates in the period, helping to maintain the level of consumption when income and employment levels fell. Federal transfers have been much higher than domestic savings as a percentage of GDP since 1974 (see Figure 4). For the period as a whole (1960-2001), domestic savings as a share of GDP amounted to 3.7%, while net transfers to individuals amounted to more than 10%.

¹⁵ By the 1990s, Puerto Rico provided 50% of U.S.' pharmaceutical imports and close to 25% of the worldwide demand for drug products.

Table 7:
PUERTO RICO - Matrix of correlations, 1960-2001

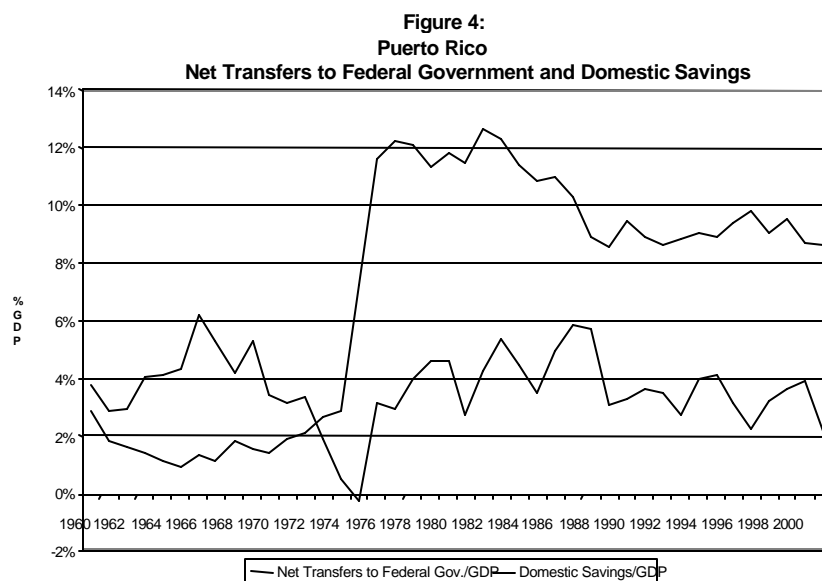
	<i>Total Gross Domestic Investment/GDP</i>	<i>Net Inflow of External Capital, adjusted/GDP</i>	<i>Domestic Savings/GDP</i>	<i>Net Transfers to Individuals/GDP</i>	<i>Total Net Transfers Federal Gov./GDP</i>	<i>Unemployment Level/Labor Force</i>
Average Share of GDP 1960-2001	20.67%	15.66%	3.66%	10.28%*	7.12%	14.87%
Total Gross Domestic Investment/GDP	1					
Net Inflow of External Capital, adjusted/GDP	0.39	1				
Domestic Savings/GDP	-0.12	-0.22	1			
Net Transfers to Individuals/GDP	-0.88	-0.22	0.00	1		
Net Transfers from Federal Gov./GDP	-0.92	-0.29	0.05	0.99	1	
Unemployment/Labor Force	-0.76	0.01	0.05	0.80	0.78	1

Source: ECLAC, on the basis of data from Puerto Rico's Junta de Planificación.

* This share, given the availability of information, corresponds to the period of 1963 to 2001.

Furthermore, the high level of sustained inflows of external capital was fundamental to finance Puerto Rico's investment rate during the period, given the low level of domestic savings. The inflows of external capital averaged almost 16% of GDP in the period, what helps to explain the investment rate of almost 21% (see Table 7).

During the 1960-2001 period, federal transfers showed a strong negative correlation with the rate of investment as a share of GDP, and a strong positive correlation with the unemployment level as a share of



Source: ECLAC on the basis of data from Puerto Rico's Domestic Accounts.

¹⁶ See Hausmann (1995), who pointed to the strong correlation of net federal transfers with the business cycle from 1960 to 1993.

the labor force. The correlation between the investment ratio and the unemployment rate was also strong and negative. Federal transfers were thus strongly correlated with the business cycle, assuming a fundamental counter-cyclical role.

In addition to the effect of transfers on the economy, the massive migration of Puerto Ricans to the U.S. also played a mitigating role. Puerto Rico's industrial sector was not capable of absorbing labor at the desired level resulting in a high unemployment rate in the postwar period.¹⁷ Since the 1950s, unemployment has exceeded 10% of the labor force. The unemployment rate reached its lowest level in 1970 (10.3% of the labor force), and its highest level in 1983 (23.5% of the labor force). The unemployment rate decreased in the 1990s, but still remained above the 1970 minimum.

It is hard to imagine how Puerto Rico's high level of unemployment in the postwar period would have been sustainable in the absence of unrestricted out-migration and the significant level of federal transfers. Net emigration reached almost one million persons in the period 1950-1990, declining from a peak of 42,200 per year in the 1950s, to 15,700 in the 1960s, and 9,200 in the 1970s. Net emigration increased to an average of 27,600 per year in the 1980s, however (see Table 8). According to Puerto Rico's Planning Board, net emigration reached a total of 62,169 persons in the 1990-2000 period, almost 2% of Puerto Rico's total population in the year 2000.

**Table 8: Net Emigration
Puerto Rico 1950-2000**

Period	Net Emigration	
	Annual Average (1,000s)	
1950-1960		42.2
1960-1970		15.7
1970-1980		9.2
1980-1990		27.6
1950-1990		23.7

Source: Baumol and Wolff (1996).

¹⁷ For an analysis of Puerto Rico's insufficient creation of employment see Santiago (1992). A wage policy more adapted to Puerto Rico's factor endowments and a larger proportion of local capital in manufacturing investment

The role played by tax incentives, transfer payments and unrestricted migration to the mainland, in fostering economic growth, has been subject of debate in the economic literature on Puerto Rico.¹⁸ For instance, Baumol and Wolff (1996) suggest that annual growth in GDP per capita in Puerto Rico during the 1950-1990 period would have been impressive (3.8%) even without these advantages, only about 10% less than the actual rate. However, their results also show that, although the effects of these special advantages were very small in the 1950s and 1960s, they became important to Puerto Rico's growth during the 1970s and 1980s.

Baumol and Wolff suggest that federal transfer payments during the 1970s, which came to represent more than 20% of Puerto Rican personal incomes (between 1975 and 2001, transfers to individuals averaged 15% of GDP, compared to an average of only 5% from 1960 to 1975), may have added a full percentage point to the growth in GDP per capita. In the 1980s, federal transfers added almost half a percentage point to GDP per capita growth.

Furthermore, these authors estimated that emigration added another quarter of percentage point to GDP per capita growth during the 1980s. Other authors point to a stronger effect. Notwithstanding the controversy over the extent of the effect of migration, it is clear that the unemployment rate would have been even higher without migration, which served as a safety valve, supported incomes, and allowed per capita income to increase more rapidly.

might have produced a somewhat more balanced economy in Puerto Rico, capable of absorbing a bigger share of the labor force.

¹⁸ On this controversy, see Baumol and Wolff (1996) and Dietz (2001). A major issue in the debate is the sustainability of Puerto Rico's development strategy.

5. TOWARD INCREASED COOPERATION

The gains that many countries could obtain from the FTAA will depend on the availability of adequate technical assistance. The need to strengthen the capacity of countries to implement FTAA disciplines and participate fully in the FTAA has already been acknowledged in the Hemispheric Cooperation Program (HCP) launched by the Ministers responsible for Trade in Quito on November 1, 2002. The HCP envisages the provision of technical cooperation to address the institutional constraints that can be an impediment to meeting the obligations assumed under the agreement.

The HCP also recognizes that overcoming the challenges associated with trade liberalization in the FTAA involves more than technical assistance to implement common disciplines. The HCP envisages, *inter alia*, cooperation for “adjusting to integration.” This would include the strengthening of productive capacity, fostering competitiveness, encouraging the development of innovation and the transfer of technology. If successfully developed and implemented, the HCP can make an important contribution to addressing many of the constraints of the smaller and less developed economies.

However, for the FTAA process to contribute to income convergence in the hemisphere, it must meet several additional requirements. As we have indicated, the way asymmetries are dealt with in the FTAA will be a crucial determinant of the capacity of developing country partners of the agreement -- particularly the smaller ones-- to benefit from an expanded hemispheric market. The gains that many countries could obtain will depend on their success in transforming productive structures and strengthening the export-GDP growth linkages. This involves policies to stimulate and diversify exports, and to speed up innovation and technological development. Progress on this area will depend on adapting the practice of leveling the playing field to the realities of countries in the hemisphere, and thus preserving flexibility in FTAA obligations to adopt active production development policies to improve competitiveness.

In addition, gains will depend as well on curbing the vulnerability of the economies to capital flows. This, in turn, means that there must be sufficient autonomy to adopt counter-cyclical macroeconomic policies, including capital-account regulations. As mentioned earlier, regulations of capital flows give additional room to moderate cyclical upswings and avoid unsustainable appreciation of the exchange rate, thus serving as a complementary tool of sound macroeconomic policies. Through its effects on the real

exchange rate and its stability, it may also serve a sustainable transformation of productive structures in the face of deeper trade liberalization.

Finally, free trade, even with special provisions that take asymmetries into account, may be insufficient as a force for between-country income convergence. Two fundamental complements are cohesion/integration funds and increased labor mobility. Funds can play a key role in accelerating convergence of income levels within the hemisphere. As the experience of Puerto Rico illustrates, such transfers can play a crucial role in alleviating economic and social adjustment costs in the more disadvantaged areas, and can also provide a useful counter-cyclical device.

The European Union is obviously the case where this principle has been applied most forcefully. It is indeed symptomatic of the political philosophy underlying European integration that deepening economic integration during the final decade of the twentieth century was accompanied by the increased use of explicit cohesion policy (Marín, 1999). What is more, this policy was extended to the Central and Eastern European countries that are candidates for joining the Union. The possibility of setting a cohesion or integration fund to provide the necessary backing for hemispheric agreement was put forward by the number of Heads of State at the Summit of the Americas held in Quebec in April 2001¹⁹ and therefore warrants special attention.

Labor migration can also be a major force for a more equitable distribution of FTAA gains. Along with liberalization of trade and investment, inclusion of labor mobility in the hemispheric agenda could have an equalizing force. As Rodrik (1997) has shown, the lack of labor mobility relative to that of capital skews the distribution of income against the less mobile factor, particularly the abundant low-skilled labor in the developing economies.

Thus, the key for labor mobility as an equalizing force is to include not only skilled workers but also less skilled workers.²⁰ Winters (2002) has estimated that movements of workers for limited periods of time from developing to industrial countries could produce gains that exceed the full liberalization of trade in

¹⁹ The President of Mexico made particular reference in Quebec to a cohesion fund, and a number of prime ministers from the Caribbean drew attention to the importance of integration funds. The Government of Ecuador, which coordinated the negotiations until November 2002, later proposed that a fund be established to promote competitiveness.

²⁰ In NAFTA, the movement of natural persons is limited to business personnel.

goods.²¹ These results suggest that global gains from unskilled labor mobility exceed those from skilled labor mobility.

Labor mobility is no doubt a controversial subject. Economic theory indicates that an inflow of low-skilled workers from developing countries would put downward pressure on wages of unskilled workers in industrial countries. This is supported by empirical evidence, which indicates that the inflow of unskilled workers to the U.S. has contributed to a decline in the relative earnings of unskilled workers, thus exacerbating the skill bias of technological change (Borjas, Freeman, and Katz 1997).

It has been suggested that a mitigating factor is that demographic trends in the U.S (and in other industrial countries as well) would lead to rising relative wages for unskilled labor. As a consequence, there would be a good potential for increased flows of unskilled workers in an environment of stable relative wages (World Bank, 2002). Moreover, immigrant workers can play a crucial role in meeting a country's growing need for labor. As recent research suggests, the economy of the U.S. in the 1990s was overwhelmingly dependent on immigrant workers for its employment growth (Sum, Fogg, and Harrington, 2002).

On the other hand, a selective migration policy that favors skilled labor mobility increases income gaps in source countries. It also drains their human capital, generally a scarce factor of production, and may thus become an additional determinant of income divergence. Furthermore, skilled labor may end up being employed in jobs requiring lesser skills in the recipient countries, due to other disadvantages it faces (language disadvantages, lack of knowledge of recipient labor markets, inadequate educational accreditation agreements, etc.). This implies that, from the point of view of source countries, a more balanced migration policy in recipient or even a bias in favor of unskilled labor is certainly preferable.

Greater collaborative action on this highly sensitive economic and political issue could take place within the Summit of the Americas process, which provides the broader framework for the FTAA. Already the Summit offers opportunities for greater collaborative action and its agenda includes explicit commitments on migration, human rights and equity, and calls for the strengthening of cooperation among the countries to address these issues.

²¹ The effects of increasing temporary workers' permits industrial countries by 3% of their current skilled and unskilled forces would produce economic benefits exceeding \$150 billion per year, compared with those of \$66 billion for complete goods trade liberalization, shared between developed and developing countries.

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