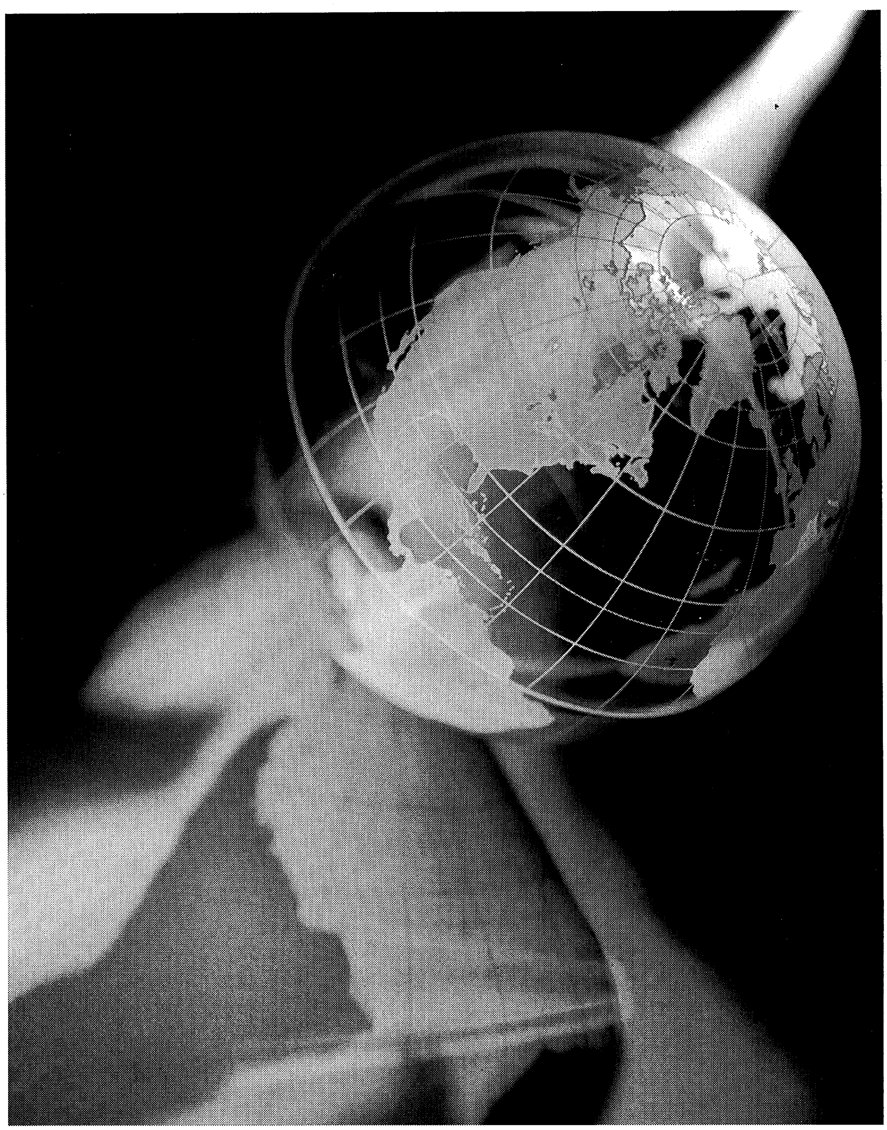
ECONOMIC INTEGRATION IN THE WESTERN HEMISPHERE

Edited by Constanza Valdés and Terry Roe

April 1997



PROCEEDINGS OF A SYMPOSIUM SPONSORED BY THE

INTERNATIONAL AGRICULTURAL TRADE RESEARCH CONSORTIUM

AND THE INTER-AMERICAN INSTITUTE FOR COOPERATION ON AGRICULTURE

JUNE 7-9, 1995 SAN JOSÉ, COSTA RICA

SESSION 1. EVOLUTION TOWARDS REGIONAL INTEGRATION

Joining an Existing Regional Trade Agreement: Issues and Policies from the Perspective of a Small Open Economy in Latin America

Alberto Valdés, World Bank[1]

Introduction

Latin American countries began to open up their economies in the late 1980s following decades of protectionism, effectively putting an end to four decades of import substitution policies. Most countries had relied on quantitative restrictions before this and, in most cases, high tariffs were used in order to protect the production of importables. In several countries, agricultural exports were taxed directly; moreover, agriculture suffered extraordinarily high indirect taxation from industrial protection and macroeconomic policies (Schiff and Valdés, 1992).

For most of Latin America, a bold program of unilateral trade had already occurred in April of 1994, the time of the Uruguay Round Agreement (URA). These reforms have exceeded the requirements of GATT, and therefore, with some exceptions, the URA for agriculture is not likely to cause major adjustment problems in the countries concerned (Valdés and McCalla,1995).

Following the strong trade reforms of the late 1980s and early 1990s, many countries in the region are facing new policy and institutional challenges. One major policy challenge is to maintain open trade regimes in the face of continuous pressure to protect one sector or another. A second challenge is to push the trade liberalization agenda further; the URA provides new opportunities for increasing trade under a hopefully improved market access. Not all trade liberalizations were completed in LAC countries, and some of the trade related institutions such as customs administration and rules for dealing with contingency protection measures (safeguards, anti-dumping, etc.,) remain out of step with liberalized trade (Rajapatirana, 1994).

Preferential trade agreements have taken on an astonishing prominence more recently in the trade policy debate of the post-Uruguay round in Latin America. Regional agreements are 'in' and trade agreements proliferate: Mercosur in the Southern Cone of South America; NAFTA in North America; the Free-Trade Area for the Americas agreed at the Summit for the Americas in Miami, are among the most recent initiatives and the 'older' treaties, such as the Andean Trade Preference Act; the Caribbean Basin Initiative; and Central America's trade agreement. These agreements are dominating the current debate on trade policy in the region. Add to these the numerous bilateral agreements and trade preferences under ALADI, Chile and Mexico's membership in APEC, Colombia, Mexico and Venezuela (the G3) and others, an increased commitment to regional and subregional trading arrangements is revealed. This obsession with preferential trade agreements raises several questions. Does this regional approach mean a slow down of the reforms in the trade regime from a multilateral 'MFM' perspective? Is Latin America and NAFTA

---

[1] Presented at the conference on Economic Integration in the Western Hemisphere, co-sponsored by the International Agricultural Trade Research Consortium (IATRC) and the Inter-american Institute for Cooperation on Agriculture (IICA), San José, Costa Rica, June 7-9, 1995.

moving in the direction of closed trading blocks? Or, quite the contrary, one could expect that these regional agreements might speed up liberalization within the regional agreements and between sub-groups and non-members? Are these overlapping preferential agreements likely to create a morass of bureaucratic procedures making enforcement of commitments rather unworkable? Hopefully this conference will help elucidate these questions.

Agriculture is rapidly becoming one of the most contentious issues in the regional agreement as was demonstrated also in the URA negotiations. This sector's requirements are particularly contentious because they are taking place against a backdrop of stress on profitability experienced by agriculture in several countries. This phenomenon - reflected in a decline in (red) farm prices in domestic markets - has lead to an intensive pressure for protection for import-competing subsectors. The main factor underlying the decline in real (domestic) farm prices is the exchange rate appreciation (mainly due to large capital inflows) observed during the early 1990s; a phenomenon which was amplified by the tariff reductions and removal of QRs, reducing (real) farm prices even further. An eventual integration with Mercosur, or with NAFTA, will increase the pressure for competition among some import-competing subsectors (traditional crops), as well as open up new opportunities for exports. Thus, the design of a negotiating strategy for a country usually takes the form of minimizing the potentially adverse effects on importables, and maximizing the potential benefits on exportables. The fairly recent exchange rate phenomenon occurring in several countries in Latin America will, I believe, profoundly influence the local perception as to expected benefits and costs from joining an FTA. To the extent that this exchange rate appreciation is a temporary phenomenon, it could distort the negotiating strategy of these countries.

This paper attempts to identify important analytical issues involved in the joining of an existing trade agreement from the perspective of a small open economy in Latin America. As such, this paper does not examine the global welfare implications of such initiatives. The analysis considers the possibility of joining NAFTA whilst simultaneously exploring a special preferential status with other subregional agreements. Chile, for example, is considering the possibility of joining NAFTA while simultaneously negotiating a preferential status with Mercosur (Chile is not a member of Mercosur nor of the Andean Group). Colombia, Peru, or Venezuela could consider the same option. These countries all belong to the Andean group and have expressed interest in joining NAFTA. Argentina, a member of Mercosur has expressed an interest in joining NAFTA. Hopefully, the framework presented could be useful in delineating a negotiating strategy.

The first part simply identifies two important issues regarding the debate on multilateralism versus free trade areas, namely the potential effect on the level of external trade barriers (applying third country imports) and rules of origin as a key element. The second part attempts to identify arguments for and against joining an established FTA. The last section concludes with some thoughts on a negotiating strategy for a small open economy that is considering joining an FTA.

Multilateralism and Regional Trade Areas (RTAs)

It is generally accepted that multilateral treaties based on the most favored nation (MFN) principle-equal treatment of all on a multilateral basis - have succeeded in expanding world trade over the past decades. Most trade economists agree that MFN based trade is the most successful and that departure from MFN is good only if it leads to GATT-plus trade, i.e., more net trade is created than possible under MFN trade liberalization on a unilateral basis. Across products worldwide, there has been much greater trade expansion under MFN basis than under preferential trade (Rajapatirana, 1994). See McCalla (1992) for a synthesis of the empirical evidence of the impact of preferential trading arrangements on agriculture.

A large proportion of this growth in trade is occurring within certain regions, although not under preferential market access, such as in Asia. This is not always the case for agricultural trade, and the clearest case is the growth of inter-European Union (EU) agricultural trade, which is far above the growth of inter-regional trade for that block (Josling 1995).

Latin American RTAs have not lead to significant trade expansion in the past, due to the protectionist approach, discriminatory practices and complex regulations. Most countries in the regions followed inward-looking policies, and the subregional RTAs departed from MFN treatment ending up with reducing trade and isolating the local economies from the rest of the world. It is not trivial to remember that several countries joined GATT only recently (Mexico in 1986, Bolivia and Costa Rica in 1989, El Salvador, Guatemala, Honduras, and Venezuela in 1991).

However, a new and critical element in the early 1990s is that RTAs in Latin America are now being negotiated in the context of countries which had already began a unilateral liberalization of their trade regime. Thus, the question is to what extent RTAs are raising the trade barriers to nonmembers. So far, the answer is that they have not raised them. However, as argued by Primo-Braga and Lustig (1994), there are some caveats to this assessment. One is whether the common external tariff results in higher trade barriers. The second is the potential protectionism element regarding the rules of origin.

If the RTAs do not raise their barriers to nonmembers, the scope for trade diversion (e.g. divert trade from lower cost exporters outside the block to higher cost exporters within the block) is weaker. However, some critics of the RTAs believe that the determination of the common external tariff in the case of the customs union will probably not converge to the lowest tariff levels. That is, for a number of goods it will result in tariffs higher than those maintained by the member with the lowest tariff for a number of goods. We should remember that the URA (Art.XXIV) provides some GATT guidelines and disciplines with respect to regional arrangements. Customs unions would be GATT compatible if the weighted average tariff against nonmembers does not increase with the formation of the customs union, although it could increase at specific tariff levels.

Particularly for free trade areas, rules of origin raise a complex issue for agricultural trade in RTAs. Rules of origin are necessary in a free trade area or in a customs union to determine which goods are entitled to preferential treatment. Under free trade areas, they are needed to prevent exporters outside the trade area using a partner with lower trade barriers to tranship exports to more protected markets within the area. Within a customs union, they determine the domestic content requirement. However, most primary agricultural products are fairly homogenous commodities, and thus it is hard to run rules of origin effectively, which has made analysts wonder whether free trade area arrangements will gradually evolve towards a custom union arrangement, at least for primary agricultural commodities.

The Benefits and Costs of Joining an RTA

a) The most frequent empirical question regarding the costs and benefits of RTAs is the classic *trade creation versus trade diversion effects*. The amount of trade creation versus diversion will depend on the initial conditions in the countries concerned regarding tariff levels and non-tariff barriers (NTBs), tariff escalation, and products excluded from the preferential agreement.

Trade diversion (increased trade with higher cost trading partners) can be large if the country joining an RTA is more open than the RTA. For example, if Chile which has an 11% uniform tariff on imports were to join Mercosur, which has agreed on a common external tariff of 20% (ranging from 0 to 20%), it would be joining an RTA which is more protectionist, thus resulting in an increase in Chile's tariffs with respect to non-Mercosur members. Trade diversion in the case of joining NAFTA would be less because NAFTA economies have lower trade barriers than Mercosur, and NAFTA economies are so much larger than Mercosur. However, joining NAFTA would still imply some trade diversion as a large proportion of Chile's imports (consumer durables) come from Asia and Europe, and because NAFTA exportables are not perfect substitutes with these other sources.

However, potential trade diversion effects on agricultural products are reduced considering that they are fairly homogenous products and thus probably have high substitution elasticities.

b) *The cost of being excluded from an RTA* as perceived by a country that wants to join may be important. Baldwin's (1993) *domino theory* comes to mind as a relevant framework in attempting to explain the recent series of calls by prominent political leaders in Latin America for regional agreements. Baldwin's theory is based on the outcome of political forces within a country. He argues that once an RTA is established between two or more 'large' countries there is political pressure on the governments of third countries to join the RTA, pro-membership forces visualize a loss in their export markets to member countries as a result of the agreement. If these non-members do eventually join the RTA and expand the trade bloc, there is further pressure to join from other countries that are still left out. Baldwin concludes that this process lasts until a new political equilibrium (within each country) is reached and anti- and pro- membership forces are once again in balance.

An example of this is Chile and Mercosur. Although from a static creation/trade diversion perspective Chile might benefit from not joining Mercosur, there are pressures on Chile in favor of becoming an associate member of Mercosur (Chile would keep its external tariff schedule, which is lower than Mercosur's). The concern is that Chile might lose export markets in Brazil and Argentina, which are important for certain products, as a result of a trade diversion in the Mercosur market. Between 1991 arid 1993, Chile had signed preferential agreements with Argentina, Bolivia, Colombia, Mexico, and Venezuela, had become a member of APEC, and had initiated negotiations with NAFTA. Another example is Colombia which had signed more than 20 free trade agreements with the rest of Latin America between 1991 and 1994.

c) *Reducing uncertainty of market access could induce an expansion in local investment for producing exportables.* The experience shows that large economies such as the United States can unilaterally adjust access conditions to exports from small economies, and stop imports for a substantial period of time. The delay in resolving these disputes can mean the end of an otherwise profitable exports for the small economy, particularly for perishable products. Non-tariff barriers (NTBs) are the preferred instrument used by the larger economy, and sanitary and phyto-sanitary regulations head the list of preferred instruments to block the entry of imports. The presumption is that by becoming a member of an RTA, such as NAFTA, and due to clearer rules and established procedures regarding the resolution of disputes, there might be less uncertainty regarding unilateral action affecting exports from the smaller economies. The case of cut flowers from Colombia, the infamous case of the 'poisoned grapes' from Chile into the United States, etc., are still fresh in the memory of exporters in those countries.

d) *The cost of joining an RTA in which some members have a history of unstable macroeconomic conditions*. Volatility in the real exchange rate between members can rapidly be transmitted to domestic prices, introducing great uncertainty affecting employment, trade flows, and fiscal revenues. Depending on the degree of economic integration, the larger the economy of a member with unstable policies, the greater is the effect on the smaller economies. As Krugman (1993) notes, for a large country such as the United States, any significant change in the economy caused by changing trade flows under an RTA could be easily offset by a change in domestic monetary policy. The Federal Reserve, faced with the prospect of a reduction in US employment because of rising imports from Mexico, could set interest rates lower than it otherwise would have. After concluding that the most pessimistic estimates of job losses due to NAFTA do not exceed 500,000 - less than half of one percent of US employment - Krugman (1993) argues that

> "a job loss (or gain) in the order of half a percent (in the US) is small change compared with the effect of Federal Reserve policy. Such a change can and will be offset by a change in interest rates of a fraction of a percentage point".

The United States has a flexible exchange rate system and a "deep" financial market which permits the use of monetary policy to offset external macroeconomic shocks. By contrast, the Latin American economies typically intervene directly in the foreign exchange market avoiding large fluctuations and are fairly constrained in their possibilities of using interest rate policy to offset external shocks. One reason for this is that the interest rate is usually tied to price stabilization targets, and secondly, because the level of 'monetization' of these economies (M/GDP) is typically a fraction of that prevailing in industrial countries. Thus, for a small, open and macroeconomic "stable" economy, the combined effect of trade and capital flows from "large" and macroeconomic unstable partners in an FTA can be very hard to offset. Argentina and Brazil have a long history of highly unstable macroeconomic policies. By contrast, Canada and the United States are more stable, thus, the advantage of NAFTA vis-a-vis Mercosur for Chile or Colombia.

e) *FTAs and environmental standards*. For the smaller economy, environmental problems in foreign trade are centered around their exportables. It is useful to distinguish between those that concern the finished products (demand) and those related to the production process (supply) of agricultural exportables. GATT has generally backed trade sanctions based on demand criteria, justified directly in terms of a possible damage to consumers in the importing country, but has not backed sanctions based on environmental criteria related to the production process. However, negotiations with the United States could include supplementary negotiations which could impose some trade restrictions related to environmental concerns on the supply side. The latter could include run-off of agricultural residues, water pollution, labor standards for workers exposed to agrochemicals, and others.

As was the case concerning trade and wages during the negotiations of the United States, Canada and Mexico, environmental concerns easily become a political issue under an FTA with the United States. This strengthens the hand of local lobbies who can demand costly environmental measures in the Latin American economy. It is paradoxical that, because the United States is a very open economy, countries such as Chile and Colombia have access to the market without having to raise their environmental standards (on supply) as would be the case should they join NAFTA.

An analysis on environmental issues by the World Bank (1994) for Chile under a scenario of negotiations with the United States, concluded that the principal concerns for Chilean agriculture were centered around the production process. These were: (i) weak supervision and enforcement of the relevant legislation; (ii) inadequate information on the effects of some toxic substances on the environment and on finished products; and (iii) inadequate legislation regarding run-off of agricultural residues. According to the World Bank, the greatest problem is not the content of environmental regulation, but deficiency in supervision. The bottom line is that more government and private sector resources would have to be allocated to this task, increasing local production costs.

f) *Joining an FTA could have positive externalities such as:*

* complying with higher environmental standards on exportables may also lead to better access to third country markets, e.g., Japan and the European Union. This would probably arise if the country were to joining NAFTA;

* joining an FTA with neighboring countries (Chile and Mercosur) could bring about higher returns for joint investments in infrastructure, such as ports, roads, energy, and others;

* the potential benefits from increased credibility in domestic policies, reducing the country risk which may lead to greater foreign investment.

g) *The potential benefits from a reduction in tariff escalation* faced by smaller countries exporting to the United States. In the United States, tariff rates for agriculture, fishery and forestry products increase with the level of processing (Butelman 1994). This bias against exports of processed foods to the United States is apparently very important for Chilean agriculture. A recent study (World Bank, 1994) on the potential effects for Chile were to join NAFTA concluded that while primary agricultural exports to the United States could increase by 5.8% due mainly to an increase in exports of grapes (other fruits and vegetables are less affected by NTBs and tariffs), exports of agro-industrial goods to the USA could increase by as much as 43% (tomato concentrates, fruit juice, frozen fruits and vegetables, and others). In other words, as a price taker in the United States, Chile would benefit from some gain in its export prices of processed foods. This tariff escalation phenomenon probably applies also in Mercosur's common external tariff, and thus there is a potential terms of trade gain for a new member. The advantage of NAFTA vis-a-vis Mercosur in this regard is obviously the much larger size of the NAFTA economies.

h) *On sequencing of applications to Mercosur vis-a-vis NAFTA.* For countries which today are outside NAFTA and Mercosur, Butelman (1994) has raised what seems to be a relevant consideration on sequencing regarding application to these trade areas. At the Summit Meeting of the Americas in Miami in 1994, it was decided that a free trade agreement (FTM) should be implemented for the whole Western Hemisphere region by the year 2005. On the other hand, Chile or Colombia's application (or the application of Bolivia, Peru or others for that matter) to Mercosur would not be considered until five years after the implementation of Mercosur in December 1994, that is by the year 2000. Under this schedule, Mercosur would then become subsumed into the FTAA in the year 2005, about the same time that Chile or Colombia would be reaching the full member status of Mercosur. Thus, the market access advantages of joining Mercosur would be short-lived.

Concluding Comments

Several countries in Latin America have an advanced program of unilateral trade liberalization, which includes agriculture. This is the case for Argentina, Bolivia, Chile, and Peru. To advance further along this unilateral route will require further institutional development, such as the implementation of better customs administration, and better systems designed to deal with contingency protection measures (safeguards, anti-dumping and countervailing duties). However, the major reforms are already in place.

Although these countries have important segments of their markets in Europe and Asia, they cannot escape the fact that a large segment of the regional economy is now part of an RTA. Members outside these RTAs are unlikely to remain passive against trade barriers such as tariff escalation, NTBs such as sanitary and phytosanitary restrictions, seasonal tariff surcharges, and the sometimes discriminatory treatment they receive on services attached to their exports in Latin America and North America. This is particularly important for agricultural trade. A policy option being considered is exploration of the potential for deepening their market access for exports within the region through RTAs. The economic blocks are a reality today, and non member countries feel the competitive pressure for their exports to RTA member countries and the preferential treatment given to their competitors exporting from within the RTA. As argued earlier in the text, the cost of being excluded from an RTA could become high.

For a small open economy in Latin America, joining an existing regional trade agreement raises several challenges and options.

Firstly as a general criteria, conditions for minimizing the risks of trade diversion involve having the lowest possible level of protection in the domestic economy, and the negotiation of further reduction in protection in the trade partners when entering an RTA. Furthermore, enhancing competitiveness for the domestic economy implies low trade barriers, complemented with the harmonization of the tax and regulatory policies, better infrastructure, more developed financial markets, and other reforms.

On whether NAFTA or Mercosur, NAFTA appears to be more favorable. It is a larger market, its macroeconomics is more stable (Mexico's crisis notwithstanding), and other favorable conditions discussed in the text. Moreover, eventually Mercosur would become subsumed under NAFTA if the agreement at the Summit of the Americas is implemented.

However, joining NAFTA does not necessarily rule out the possibility of an association with Mercosur, not as a member of the custom union (common external tariff but as an associated partner under preferential treatment.

From the perspective of this new potential partner in an RTA, ideally some harmonization between NAFTA and Mercosur would be desirable, in order to facilitate their implementation and to reduce conflicts. Especially critical is the need to avoid contradictory regulations regarding rules of origin, and harmonization of contingency protection (safeguards, anti-dumping and countervailing duties), government procurement, and technical norms and standards.

If our prototype country does join an existing RTA, the agriculture in this small open economy is inevitably going to be faced with the need for profound adjustments in its import-competing sector. Practically everywhere in the region, importables are protected. For example, were Chile to enter NAFTA, local producers of wheat, maize, and oil seeds would be faced with strong competition from the United States and Canada, and the current scheme of price bands on wheat and sugar might come under fire. These same subsectors plus sugar, beef, and rice would be adversely affected in a negotiation with Mercosur. These are major sectors of the Chilean agricultural economy. The strategy for enhancing the competitiveness of these subsectors without postponing their reconversion to other activities for those segments that cannot compete is the major policy challenge ahead. Exchange rate management and reducing the cost of financial intermediation will be very influential factors in the agricultural adjustment of these countries.

References

Baldwin, R. "A Domino Theory of Regionalism," NBER Working Paper No.4465, September, 1993.

Butelmann, A. "Elements of Chilean Trade Strategy: The United States or Mercosur?" in R. Bouzas and J. Ros (eds.) *Economic Integration in the Western Hemisphere*, Univ. Notre Dame Press, 1994.

Josling, T. "Agriculture, Global Trade Liberalization and the Process of Regional Integration." Paper presented to the International Seminar on "Agricultural Policies and Regional Integration Processes after the Uruguay Round: European Union, MERCOSUL and NAFTA," Rio de Janeiro, May, 1995.

Krugman, P. "The Uncomfortable Truth about NAFTA," *Foreign Affairs*, Vol. 72, No.5, November/December, 1993.

McCalla, A.F. "GATT, Preferential/Regional Trading Blocs and Agricultural Trade," *Review of International Economics*, Vol. 1(1): 73 89, 1992.

Rajapatirana, S. "The Evolution of Trade Treaties and Trade Creation: Lessons for Latin America," World Bank Policy Research Working Paper No. 1371, October, 1994.

Schiff, M and Valdés, A. "The Political Economy of Agricultural Pricing Policy," *A Synthesis of the Economics in Developing Countries. A World Bank Comparative Study*. John Hopkins University Press, Vol. 4, 1992.

Valdés, A. and McCalla, A. "The Uruguay Round (GATT) Agreement on Agriculture and the LDCs." Paper presented to the International Seminar on "Agricultural Policies and Regional Integration Processes after the Uruguay Round: European Union, MERCOSUL and NAFTA," Rio de Janeiro, May, 1995.

World Bank. "Chile: Strategy for Rural Areas - Enhancing Agricultural Competitiveness and Alleviating Rural Poverty," Background Volumes I and II, Annexes C and J., August, 1994.