INSTITUTIONAL RULES AND MECHANISMS FOR WESTERN HEMISPHERE TRADE

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Executive Summary: An Empirical Investigation into the Trade and Investment Effects of a Southern Hemisphere Free Trade Agreement*

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EXECUTIVE SUMMARY: AN EMPIRICAL INVESTIGATION INTO THE TRADE AND INVESTMENT EFFECTS OF A SOUTHERN HEMISPHERE FREE TRADE AGREEMENT

The year 1994 saw the ratification of the North American Free Trade Agreement (NAFTA), a trade agreement between the United States and Mexico which calls for the gradual phasing out of numerous government-erected barriers to trade (essentially in fresh fruits and vegetables), including both tariff and nontariff restraints. Proponents of the legislation contend that with the elimination of artificial inefficiencies NAFTA will result in increased production, the efficient allocation of resources, increased investment, and decreased prices for the consumer. Concurrently, some have argued that including additional Latin American countries in NAFTA or a similar free trade arrangement will result in even greater economic efficiencies and benefits.

The plausibility of increased trade is further buttressed by the recent changes occurring within the U.S. fresh fruit and vegetable market relative to both U.S. and Latin American productive capacity. Indeed, between 1970 and 1992, domestic per capita consumption of fresh fruit increased from 79.2 to 98.8 pounds, while the fresh vegetable market witnessed a corresponding increase from 110.6 to 133.4 pounds. At the same time, domestic supply remained relatively static, with technologically-based efficiencies at least partially offset by decreasing acreage under cultivation. As a result, while fresh fruit and vegetable imports accounted for 18 percent of domestic consumption in 1973, this had increased to 24 percent by 1992. When the relevant market is limited to fresh fruit, the increase was even more dramatic, rising from 28 percent in 1973 to 39 percent in 1992. Further, demographic and other changes strongly suggest a rising domestic demand in the foreseeable future.

With these aggregate economic considerations as background, this paper addresses the opportunity to establish new rules and mechanisms to promote freer trade and investment in the Americas, and the likely effect of taking such a move. Many Latin American countries have taken and continue to take great strides in changing and establishing the infrastructure and the rules and mechanisms, both private and public, needed to take advantage of the opportunity.

This paper further addresses the likely production, investment, and price repercussions of using NAFTA or a similar free trade agreement to include the United States and selected Southern hemisphere neighbors in a regional free trade zone. Specifically, we examine the assumption that increasing the number of participants in a Southern hemispheric free trade agreement may portend lower prices, a surge of production in relevant Latin American countries, and a corresponding flow of investment to these countries as international investors realize the profit potential inherent within agreements predicated on pure comparative advantage. To further establish a preliminary estimate of the effects of extending NAFTA (or an equivalent agreement) to various Southern hemisphere countries, we will detail the effects of the 1983 Caribbean Basin Initiative on prices, production, and investment flows. Using the empirical results of this factual example, we gauge the reliability of our study's findings.

Because of the sheer volume of products that are currently traded between numerous Latin American countries and the United States, selection criteria were used to segregate specific products and countries. Although it is arguable whether some products or countries should have been included, the intent was to include a diverse selection of product–country associations. Some established product–country combinations are supplemented by combinations which possess substantial growth potential over the foreseeable future. Further, we mainly chose products for which there existed a substantial period when U.S. domestic supply alone was unable to fill domestic demand.

Six countries were selected for the study: Argentina, Chile, Colombia, Guatemala, Honduras, and Mexico. Selection criteria included: 1) the availability of sufficient data; 2) the production of particular products; 3) the country's political system; 4) the country's economic and agricultural policies; 5) the country's infrastructure; 6) the country's marketing strategies and abilities; 7) the country's natural resources and climate; 8) the government's commitment to technological advances and growth in human capital stocks; and 9) an overall measure of the country's comparative advantage vis-à-vis the United States.

Clearly these countries run the gamut of socioeconomic and political development, with strong attributes in one field potentially offset by deficiencies in another. To develop an overall description of a particular country's current and future export strength, we weight each criterion to develop a readiness-for-export index. This index provides a reasonable and consistent basis upon which to predicate country selection. However, the constraint imposed by insufficient or nonexistent data renders this study less than ideally complete. Furthermore, the most significant effects of a hemisphere-wide free trade agreement might occur in countries that currently do not export any quantity of a particular good to the United States. Hence, it is very difficult to reliably estimate the effects of decreased trade barriers on a particular country's decision to *initiate* exporting a particular product to the United States.

Several products were selected for the study, including asparagus, bell peppers, cantaloupes, cucumbers, grapes, oranges, strawberries, and tomatoes. Selection criteria included: 1) the product's price-to-weight ratio; 2) U.S. shipments; 3) the magnitude of current imports; and 4) the per capita growth in U.S. consumption over specified time periods. Similar to the country selection process already mentioned, we chose products based on both their current exportability and their future potential for export growth. Among the most attractive were those products for which future technological growth in Latin American countries might drastically alter the current competitive situation by providing these countries technologically-based lower costs in addition to their current labor-cost advantages.

One of the key determinants affecting any such study is measuring the time period each year when domestic production does not compete with Latin American production. We calculate this *window of opportunity* for each country-product combination. For some products, such as asparagus and cantaloupes, significant periods exist for which there is no domestic production. By assuming identical demand curves for domestic and Latin American products regardless of the time period, our analysis indicates substantial export potential for these products based on the current comparative advantage.

At the same time, products such as bell peppers and oranges currently have little or no window of opportunity. However, these products are included in the current study under the assumption that relaxed trade barriers could substantially increase their export potential based on lower Latin American prices.

Our examination of the existing literature and data leads us to several conclusions. Before identifying and briefly discussing these results, it is important to note, that the omission of countries which do not currently export particular products to the U.S. market may significantly understate the expected gains from free trade. It is possible that the elimination of trade barriers would provide sufficient incentive for such countries to commit resources to large-scale exportation. However, without adequate information to assess this potential, our study assumes no entry from these countries, an unlikely situation which leads to a systemic underestimation of price, production, and investment effects.

With this caveat in mind, we draw several conclusions from the current study. First, we conclude that there would be very modest price and quantity effects associated with extending NAFTA or a similar free trade agreement to the countries in question, with several exceptions briefly discussed below. Contrary to commentators and researchers who, a priori, insist on the substantial benefits of expanding free trade to Southern hemisphere countries, our study indicates that there will not be large-scale shifts of output to the U.S. market for a majority of the products studied based on current comparative advantages. Additionally, we predict relatively inconsequential price effects for consumers, with slightly higher other-market and Latin American market prices generally offset by trivially lower cross-product average prices for the U.S. consumer.

We estimate price effects using two values for the elasticity of substitution: 4.00, for a low-range estimate, and 20.00 for an upper-bound (and more realistic) estimate. Additionally, we model both the short-run and long-run effects on prices and quantities. With a substitution elasticity of 4.00, the volume-weighted short-run price effect for many of the products is less than 1 percent. When the more probable elasticity-of-substitution value of 20.00 is used, realized export prices increase, but still remain somewhat unexpectedly trivial. When the long-run price effects are examined similar results occur. Finally, the actual dollar-per-pound export price increase is typically less than half a penny.

An examination indicates relatively modest quantity effects under a systematic and inclusive free trade agreement, with a large percentage of increased imports due to other-market shifting rather than an increase in production. For example, we predict Mexican asparagus imports would increase by approximately 51 million pounds in the short run (substitution elasticity of 20.00). However, less than half of these higher exports would be the result of increased Mexican production. We predict that underlying macroeconomic conditions will result in intermarket production shifts rather than strictly higher production.

Finally, and perhaps most importantly, our study finds that investment opportunities will be substantially less than predicted by free trade proponents. If a dollar increase in output yields a forty-six cent increase in investment, and assuming a free trade agreement incorporating all countries and products examined in this study, investment will increase by between $38 million to $89 million in the short run, a relatively insubstantial amount.[1] Even in the long run, we estimate that investment will increase by only $47 million to $133 million.

There are several empirical rationales for these conclusions. First, for some product–country combinations, duties and tariffs have already been substantially or wholly eliminated, either through the Caribbean Basin Economic Recovery Act or the Andean Trade Preference Act. A large percentage of the product–country combinations have realized import duty rates of close to 0 percent. *Ceteris paribus*, for these combinations current quantities and prices already closely approximate the free trade equivalents. Without additional macroeconomic or microeconomic changes (such as technological advances or changes in preferences and demographics), many of the studied countries have little incentive to increase imports and/or domestic production based on the reduction or elimination of the already innocuous trade restrictions currently applied.

A second explanation for the relatively insubstantial trade and investment effects is the relatively small proportion of the total percentage of Latin American production allocated to the U.S. market. For example, between 1989 and 1992, only U.S. exports of asparagus and cucumbers accounted for more than 25 percent of total production by the studied countries, with a volume-weighted average of only 7.24 percent.[2] Because of the high substitutability between products regardless of production location (i.e., consumers are relatively indifferent to a choice between U.S. or Mexican tomatoes), and the resultant high substitution elasticities, Latin American producers are more likely to shift other-market exports to the U.S. market than to invest in new facilities capable of increasing aggregate production.

There are several exceptions to these findings: Mexican production of asparagus, cantaloupes, and cucumbers; Colombian asparagus; and Chilean asparagus. Our analysis indicates several reasons for this. First, relatively substantial duties exist for these particular products when exported by Mexico, Chile, and Colombia. Second, as a percentage of their total domestic production, these countries export a large percentage of these products to the U.S. market. This high ratio decreases the possibility of sating higher expected U.S. demand with other-market exports.

As the results of this study indicate, the forecast of widespread and evenly distributed benefits to countries based simply on their inclusion in an agreement which obviates trade barriers is fallacious. It presents an overly simplistic view of free trade and comparative advantage. Nevertheless, the examination of several key interactions facilitates the prediction of free trade's likely effects. First, the presence and magnitude of existing trade barriers must be determined. If, as in this study, tariff and nontariff barriers are already trivial, the complete elimination of already-reduced impediments is likely to produce only limited trade increases. Second, consideration must be given to the amount of exports allocated to a particular market as a percentage of total domestic production. When this ratio is small, it is likely that the producer will shift exports between markets rather than increase production. As the Mexican example indicates, a larger ratio of exports to total production will increasingly lead to the augmentation of productive capacity. Of course, as the particular product's elasticity of substitution decreases, the exporter will be more likely to increase production than to shift current production.

Third, careful examination must be made of the product's window of opportunity. If current demand is generally filled by the producers within the importing country, the plausibility of large-scale imports is correspondingly decreased. Finally, it is important to remember that the total benefits that result when numerous countries are included in a free trade agreement are likely to be substantially less than the sum of the benefits that might accrue to each particular country if only they were included in the free trade agreement.

INTRODUCTION

Extension of the North American Free Trade Agreement (NAFTA) and other free trade agreements to countries in Latin America was debated long before the NAFTA agreement itself was approved. The initiation of bilateral trade talks between the United States and Chile has made NAFTA expansion a recent subject of active discussion.

The exact mechanism through which additional countries will be incorporated within NAFTA remains uncertain. Although bilateral negotiations between the United States and Chile have been initiated, it is not evident whether the conclusion will be a bilateral trade pact or the expansion of NAFTA. Assuming the latter occurrence, however, one method of expansion could be a gradual enlargement of the pact with the admittance of one country at a time (and "advanced" countries like Chile would be admitted first). Another method could be through a series of bilateral agreements with the United States (and possibly Canada) which would then be incorporated into NAFTA. Finally, expansion of NAFTA could take place via admittance of "blocs" of countries, or through a round of hemispheric trade negotiations.

RULES AND MECHANISMS TO EXPAND FREE TRADE AND NAFTA

The most likely method, both for economic and political reasons, would be to expand NAFTA via a country-by-country accession to the pact in a way that would require each new entrant to adhere to the pact, its sectoral provisions, and trade and investment policies. It would be a formidable task to alter the current framework in order to suit the demands of entrants to the pact. By using a country-by-country approach, the United States would be able to maintain negotiating control in order to prevent attempts at exclusionary requests outside of a few basic export sectors.

There are no formally established mechanisms for expansion of NAFTA. Such expansion is implicit in the policy ideals of the Enterprise for the Americas Initiative, but the Initiative is deliberately vague about the exact methodology. However, as a prerequisite to acceptance into NAFTA, potential entrants would need to implement certain macroeconomic and institutional reforms. These reforms would reinforce strong economic management, provide concordance among regulatory regimes, and, in effect, serve as the mechanisms by which free trade is expanded.

For example, it is generally expected that any potential entrant to NAFTA, or any other preferential trading agreement with the United States, will have stable macroeconomic growth and market-oriented policies.[3] The Mexican government's proven commitment to economic reform, partly in anticipation of NAFTA, was crucial to the initiation of trade talks with the United States. The United States began trade negotiations with Mexico a few years after the Salinas Administration began extensive economic reforms in 1989. Other Latin American countries should expect to have similar economic stability and free market principles in place before they receive serious consideration for inclusion in NAFTA. Chile, the next candidate for inclusion in NAFTA, has had a stable economy far longer than the rest of Latin America. Most other Latin American countries have already undertaken economic and trade liberalization reform. Although no other Latin American country has yet achieved the same degree of macroeconomic success as Chile or Mexico, those countries that may be ready for NAFTA in the near future include Argentina, Bolivia, Colombia, Trinidad and Tobago, and Venezuela.[4] (See Table 1.)

The multitude of bilateral and multilateral trading agreements in Latin America presents the possibility that groups of countries, such as those in the Southern Cone Common Market (MERCOSUR), for example, could be admitted at once. (See Appendix 1 for a summary of major trading blocs and pacts in Latin America.) One of the strongest regional trading blocs in Latin America is the Group of Three (G-3) incorporating Mexico, Venezuela, and Colombia. Mexico's inclusion in the G-3 and the strength of the other two economies make this bloc a likely contender for an agreement with the United States. However, economic disparities among the members of regional trading blocs might make group admittance difficult. For example, within MERCOSUR, Uruguay and Paraguay are currently granted special tariff reduction schedules to account for their relatively weak economic positions.

The NAFTA negotiations with Mexico will serve as a good analog for negotiations with the rest of Latin America. Mexican accession to NAFTA raised issues not previously considered in the United States-Canada Free Trade Agreement, particularly with regard to the environment, workers' rights, drug enforcement, and labor mobility. Although the Mexican case was particularly sensitive given that country's geographic proximity to the United States, similar issues may be brought to the negotiating table as NAFTA is expanded in Latin America. For example, the AFL-CIO has already registered formal disapproval over Chile's possible entrance into NAFTA. Drug enforcement will undoubtedly be an issue in negotiations with Colombia. In these instances, parallels with the Mexican negotiations may serve as negotiating benchmarks.

However, it may be increasingly difficult to expand NAFTA, even if the United States maintains negotiating control and new entrants adhere to the existing NAFTA text. Rules of origin are particularly difficult in multilateral expansions. Each successive entry into the existing framework of the complicated NAFTA agreement will compound the administrative and political difficulties. And many preexisting regional arrangements, such as MERCOSUR, involve stronger commitments than NAFTA because they go beyond conventional free trade agreements. Some of these agreements have trading rules that are different from those in NAFTA.[5]

Despite the inherent complications to an expansion of NAFTA, certain macroeconomic and institutional mechanisms remain as "prerequisites" to expansion. These mechanisms for expansion of NAFTA are discussed in depth here and in Appendix 2.

MACROECONOMIC MECHANISMS FOR EXPANSION OF NAFTA

The macroeconomic policies that are crucial to a country's ability to gain acceptance to NAFTA are those that are fundamental to developing a competitive open trading and investment environment. Most countries in Latin America have embarked upon economic reform programs in recent years with varying degrees of success and completion. A summary of the current state of macroeconomic reform in Latin America is a good indication, therefore, both of the likelihood that a certain country will be admitted to a free trade agreement with the United States, and whether its investment environment is open and presents low political risk.

Mexico and Chile were among the first Latin American countries to adopt methods necessary to control fiscal deficits and inflation. Their reform programs are substantially advanced relative to the other countries, often serving as models within the region. More recently, Argentina, Colombia, Peru, and Venezuela have initiated major adjustment efforts. Most notably, Argentina has balanced its fiscal accounts and engineered a major deregulation of the economy, including privatization of $11 billion worth of state enterprises. A large domestic market and strong economy make Argentina an attractive trading partner for the United States. Other strong economies include Colombia, Peru, and Venezuela, which have been engaged in major fiscal, trade, and regulatory reforms. Brazil, the area's largest economy, which accounts for 40 percent of the region's GDP, has yet to achieve proven macroeconomic stability. In fact, Brazilian economic problems have been a source of concern within MERCOSUR, of which it is a member. Overall, the region's fiscal deficits, which averaged roughly 7 percent during the debt crisis of the 1980s, are currently less than half of that level. Average regional inflation, which had averaged almost 24 percent, is currently about 15 percent.

While most Latin American countries have enacted reforms, not all are ready to compete under the demands of a free trade agreement. An analysis of the Mexican experience prior to joining NAFTA illustrates which reforms are most needed as a prerequisite to accession into NAFTA. These can potentially serve to illustrate what types of reform are necessary.[6] (See Table 2.)

In addition, the Mexican case exemplifies the benefits that can be derived from these types of reform and inclusion into NAFTA. As recently as 1987, Mexico suffered from inflation of 150 percent per year and a large external debt burden. However, largely under the guidance of the Salinas Administration, Mexico has fostered remarkable improvements in the internal and external position of the economy. The most important economic reforms in Mexico and their status in the rest of Latin America provide a good indication of which countries are and are not likely to attract greater volumes of trade and investment in an increasingly free and competitive regional trading environment.[7]

It is crucial to note that while macroeconomic reform has been prevalent in the region, longer term development policies, such as technology development and increasing production capacity, have not been successfully undertaken on a broad scale. These longer term policies are likely to determine which Latin American countries ultimately succeed in raising their economic production and standard of living. They are also particularly valuable as indicators of future development of the agricultural sector. Technology development and improvements in the productive infrastructure are crucial for increasing production and exportation, especially in nontraditional products that require market research and development. Countries that are devoting resources to agricultural research and production of certain products are more likely to develop long-term competitiveness in these products. Overall, there has been a strong trend in Latin America toward increasing expenditures on research and production incentive programs for nontraditional fruit and vegetable products for export.

INSTITUTIONAL MECHANISMS

In the last decade, while Latin American governments were undertaking macroeconomic reforms, fundamental changes occurred at the level of the individual enterprise in the region. Large-scale deregulation and privatization efforts have been initiated. Price and interest rate controls, credit requirements, and barriers to industrial entry and exit have been disappearing.

In fact, the institutional environment for investments in Latin America has undergone incredible changes. Some institutional reforms have been fairly broad, such as provisions on the national treatment of foreign investors. Other reforms are highly specific, such as those regarding capital requirements. The microeconomic provisions of NAFTA are useful as indicators of where risks may be present. For example, the lack of intellectual property rights protection could have considerable effects on certain investments in software and technology. These measures are not uniform across Latin America, although it will be important in the future that the regulatory framework of each Latin America country is more in line with international norms.

Within the agricultural sector, the institutional environment has had a relatively greater effect on comparative advantage in Latin America than in industrialized countries because Latin American institutions are less developed and, historically, governments have implemented large-scale sectoral incentive policies (i.e., under import-substitution strategies to promote the development of national industry). Within the institutional environment the most important factors to agricultural competitive advantage are property rights, rules specifying entry conditions and boundaries on cooperative and competitive practices, licensing of producers and marketing agents to reduce transaction costs, and regulations which establish testing or inspections of products, handling procedures, nutritional labels, and product standards.

Latin America is generally in concordance with international norms in terms of property rights, intellectual property rights, and competitive practices. However, licensing, testing and standards regulations, and safety procedures are less well-established and have been the source of export problems in the past. Most Latin American producers and governments realize the need for rules and standards that are compatible with international norms in order to market competitive, quality agricultural products. Although progress has been made in Latin America with respect to improving agricultural licensing, regulations, and safety procedures, it is likely that most countries will not meet U.S. and/or international standards until required to do so by entry into NAFTA or a similar trading agreement. There seems to be little danger that the existing trading arrangements in Latin America will result in conflicts over these types of regulations, given that most countries are striving to meet and implement U.S. standards. For example, Argentina has been trying to upgrade its phytosanitary standards to concordance with Chilean standards, in order to secure access to Chilean port facilities under a recently signed economic cooperation agreement. Meanwhile, Chile is trying to implement standards that are in concordance with United States specifications in order to prevent the rejection of its exports. See Appendix 3 for an overview of the current state of trade liberalization pacts in Latin America.

IMPLICATIONS OF EXPANSION OF NAFTA

The expansion of NAFTA would be politically and economically important to the United States as a strategic response to the formation of the European Union trading block and growing inter-East Asian trade flows. Indeed, an expansion of trade flows between North and South America seems virtually assured. During the last five years, U.S. exports to Latin America have risen at an annual rate of 12 percent—more than three times the growth of total U.S. exports. United States exports to Latin America rose 16.7 percent in 1992 alone, to reach a total of $75.7 billion. The potential for further regional trade growth is evident: for each percentage point by which Latin America's combined GDP increases, the region purchases an additional $5 billion in goods and services from the United States. By contrast, for each percentage point increase of GDP in Japan, the Japanese purchase only $1 billion more from the United States.[8]

Joining NAFTA is a stated policy goal of many Latin American countries, apparently in the belief that accession to the pact will yield great benefits to their domestic producers and consumers. Membership in NAFTA will require strong fiscal and monetary policies and a liberalized macroeconomic environment. Under these conditions, NAFTA will "guarantee" a lower-risk, competitive investment climate in Latin America, which will increase the flows of foreign capital. In addition, fewer trade distortions and greater access to the American market will yield benefits to all of the Latin American economies.

In the agricultural sector, the expansion of NAFTA and removal of existing U.S. tariffs will benefit a wide range of Latin American products. Expansion could also eliminate the threat of sudden imposition of nontariff barriers, such as phytosanitary standards, by harmonizing standards and testing procedures throughout the region. On the other hand, the implementation of upgraded standards and processing procedures could be costly, especially to those countries with the least developed agricultural regulations.

NAFTA could be a considerable stimulus to export growth in the countries of Latin America, particularly if the country has a group of exports that is relatively different than the target export market, and if that country is competitive against other exporters of the same goods. For example, Chile successfully exports natural resources to the United States and other developed nations, and exports manufactured goods to other Latin American countries. The ability of a particular country to take advantage of different windows of opportunity in various export markets will determine the extent to which trade liberalization acts as a stimulus to export growth.

However, accession into NAFTA is not a guarantee of export growth for Latin America. Rather, export expansion requires the productive infrastructure and the capability to export competitive products. Inclusion in NAFTA would present significant costs to North American and/or Latin American countries, depending on the degree of trade diversion that occurs.

With respect to an expansion of NAFTA, it is clear that accession into NAFTA would be more advantageous for some countries than for others. Mexico, for example, will benefit considerably, both as the first Latin American country to sign the pact and as a large volume exporter to the other North American markets. There may be limits to the extent of benefits that Latin America receives via expansion of NAFTA. With successive entrants to the Agreement, the benefits to all previous members may be diluted. Dilution is especially likely when there are many common exports among Agreement members. The relative benefits to other Latin American signatories will depend, in part, on how important the U.S. market is for their exports and how competitive their products are in comparison to those of other pact members.

In the increasingly competitive U.S. market for fresh fruits and vegetables, expansion of NAFTA could convey significant competitive advantages to signatory countries. The U.S. market is the most important market for fresh fruit and vegetable exports from Latin America, and competition among Latin American countries and the other Southern Hemisphere producers (South Africa, Australia, and New Zealand) is intense. Small changes in the tariff structure could have considerable benefits to recipient countries and significant disadvantages to third-party producers.

Furthermore, exclusionary trade and other arrangements, such as third-party restrictions on trade and investment (in the textile, steel, auto, and agriculture sectors) could have significant impacts on the net benefits to a new entrant. Many of these sectors have been highly protected in Latin American economies; liberalization and foreign competition could result in massive numbers of firm failures. Given these potential costs, in order to derive net positive benefits from an expansion of NAFTA, Latin America would need to realize benefits from greater market access and increased foreign investment inflows under NAFTA that are greater than any preexisting trading agreements they might currently have.

It is important to note that NAFTA will not be the panacea that solves the economic woes of Latin America. A strong economy is a prerequisite to accession, and freer trade is not a guarantee of export growth or economic stability. For example, the United States, Canada, and Mexico are closely linked in trade and investment flows.[9] All three countries have large current account deficits and large accumulated foreign debts, and they need to pursue export-led growth strategies. Export growth cannot be achieved merely via intra-NAFTA trade. Instead, each country needs to improve the efficiency and productivity of its labor force and industries to compete more effectively.

Broadly speaking, there are three potential benefits to Latin American economies as a result of an expansion of trade and/or NAFTA: trade, economic, and political benefits. Trade benefits involve gains in export growth from the removal of tariff and nontariff barriers. Economic benefits involve the derived investment, efficiency, and other gains to the economy as the result of greater competition in the "freer trade" area. Political benefits can be traced to creditable economic policy commitments. These commitments emerge from the external constraints and forces needed to maintain the free trade agreement.

Trade Benefits to Latin America

No potential entrant can expect to gain as much as Mexico did from entry into NAFTA on the basis of export share in the U.S. market. The exports of all Latin and Central American countries (excluding Mexico) to the United States are smaller in aggregate than Mexico's exports to the United States. Mexico sends to the United States the highest fraction of its total exports of any Latin American economy: 74.4 percent against an average of 28.4 percent for the other Latin American countries.[10] Dilution of the benefits with each successive entrant is possible. In addition, existing U.S. import tariffs on many fruit and vegetable products are already low, and exports from the recipient countries of the Caribbean Basin Initiative enter duty-free. However, there could be gains ir specific sectors, which have historically faced high tariffs in the United States These include some fresh fruits and vegetables (asparagus, tomatoes, bell peppers, cucumbers, grapes, melons, and cauliflower) which could experience considerable gains. The prospect of economic gains in specific sectors could act as a stimulus to shift production and export toward these sectors. Such adjustments could have significant effects on the structure of comparative advantage within Latin America.

An important consideration to freer trade is whether the changes in trade flows within the region promote trade creation or trade distortion effects.[11] Significant trade distortion could ultimately produce little, or negative, results to freer trade. The degree of trade distortion will depend upon the extent of free trade pacts in the region, the external tariffs that the trade pacts implement, and the elasticity of demand for the products that are traded under the pacts.

The trade modification effects of trade diversion and creation in a free trade area depend upon whether the export basket (commodity composition) of the individual member countries are complementary goods (relatively different) or competitive substitutes. Between the United States–Canada bloc and the rest of Latin America, export products are relatively differentiated and act more as complements than substitutes (with some notable examples, such as sugar). However, within Latin America, the countries have similar export baskets and little product differentiation, such as for coffee, fresh fruit, and raw materials. Therefore, the growth of preferential trade agreements in Latin America could have significant trade diversion effects within the region.

In addition, the trade benefits to Latin America will depend on the degree to which the United States acts as a price-setter. Under trade theory, a large country which can affect the prices of foreign importers (from smaller countries) lowers the price of imports by removing tariff barriers and receives terms-of-trade benefits.

In general, trade creation will supersede trade diversion when[12]

- the initial external barrier among trading partners is high;
- the costs of production are not significantly different between the trading area members and the rest of the world;
- the trade barriers between the trading area and the rest of the world are not great; and
- the elasticity of import demand within the members of the trading area is large.

These criteria can serve as a useful framework from which to analyze the potential trade diversion and creation effects of accession into NAFTA for Latin American countries. Trade diversion within the region could be significant with respect to manufactured and high-value-added products, which typically face high tariff barriers in the U.S. market. Diversion would be more likely if NAFTA was extended slowly, country by country, than if unilaterally extended to large blocs of countries (such as MERCOSUR). However, many products, including fresh fruits and vegetables, do not face high tariff barriers in the United States, and many countries already receive preferential trading status. The degree to which tariff reductions will affect overall export growth in the region is limited. Many goods from CBI countries, including fresh and processed fruits and vegetables, enter the United States tariff-free. Extension of NAFTA to countries that are outside of the Caribbean Basin Initiative could give them a greater comparative advantage, but such an advantage would result from trade creation not diversion.

Shifts in comparative advantage will result from improved market efficiency and economic growth in Latin America, especially as more domestic and foreign capital investments are made in productive activities.[13] Those countries that implement efficiency and growth earliest could gain the most. In addition, those countries that harmonize phytosanitary regulations to U.S. standards could face less uncertainty about the imposition of nontariff barriers on their exports.

It is important to note that processed horticultural products face higher tariffs than do fresh fruits and vegetables. (See Table 3.) The agricultural processing sector is a potentially important, and growing, export sector in Latin America. Many of these countries are beginning to process fruits and vegetables for export in order to earn higher value-added revenue in the domestic productive sector. Currently, higher tariffs on processed fruits and vegetables could act as an impediment to the development of a processing base in (non-CBI) Latin America. A free trade arrangement that reduced agricultural barriers would be a considerable boost to the growth of processed agricultural goods in Latin America, and could significantly change the structure of dynamic comparative advantage in agro-industry by making Latin American producers more competitive in processed goods.

Overall, it is difficult to assess the long-term trade gains to Latin America. Most studies predict that even under the most optimistic circumstances, Latin America's direct gains from hemispheric free trade will not be great. A World Bank study concluded that if all trade barriers were removed, Latin American exports to the United States would increase by 8 percent at most. These limited gains reflect the fact that United States trade barriers are already very low for most Latin American exports. However, trade gains could result from changes in comparative advantage within the region as Latin American producers shift production toward those sectors that will benefit from tariff reductions, introduce more efficient growing methods, and implement harmonization of production standards. Since it is likely that Latin American countries will undertake these changes at differing times and with varying intensity, shifts in comparative advantage are inescapable.

Economic Benefits to Latin America

An increase in exports is not necessarily the greatest gain to freer trade for the countries of Latin America. Three other economic benefits are potentially more significant.

First, free trade arrangements with the United States would act as insurance against new U.S. trade restrictions. If Latin America does not secure significant gains from hemispheric free trade, the region would at least be assured of continued access to the U.S. market. Continued access is particularly important in agricultural trade. In the past, the United States has suddenly imposed restrictions on fruit and vegetable imports, including grapes from Chile and tomatoes from Mexico, for phytosanitary reasons. Such sudden, unilateral actions would be less likely under a free trade arrangement with harmonized standards.

Second, free trade arrangements would solidify and provide incentive toward Latin America's ongoing trade and economic reform efforts. The United States has made it clear that it will pursue free trade arrangements only with countries that are committed to stable economics, market-oriented policies, and democratic principles. Once a Latin American country signs a free trade agreement with the United States, its trade and economic reforms will be bound by international treaty, and will be less likely to be reversed by internal political turmoil.

Third, the greatest gains should come.from increasing flows of investment to Latin America. Investment growth could be stimulated in several ways. The macroeconomic reforms which are prerequisite to entry into free trade with the United States will improve business climates and increase investor confidence. Acceptance into NAFTA itself is a reassuring signal to foreign investors. Furthermore, foreign investors are more likely to attempt to use signatory countries as export-platforms to the United States, which would increase production sharing agreements and joint ventures, as well as direct investments.

An expansion of free trade in Latin America could significantly improve the international competitiveness of firms in the region. Therefore, potential entrants into NAFTA must anticipate the inherent need for a more efficient productive infrastructure.

The potential gains to Latin America from an improving infrastructure are particularly great in the agricultural sector. One of Latin America's biggest disadvantages in agricultural production is the poor quality of the transport, storage, and distribution infrastructure, which results in relatively higher costs in these activities. If inclusion in NAFTA will increase direct investments in infrastructure and productive capacity, it will surely provide a competitive advantage for the included countries. For example, Latin American governments are currently attempting to improve the quality of their infrastructures. However, scarce resources demand that most of these investments spring from the private sector. Undoubtedly, foreign investors would be more willing to invest capital into Latin American infrastructure projects in countries where their investment will be under the "protective shell" of the NAFTA framework. Accession into NAFTA can act as a positive signal to foreign investors of the maturity and stability of each member country's economic reforms, somewhat analogous to the seal of approval given to economic reform packages by the International Monetary Fund. The boom in foreign investment in Mexico, in anticipation of NAFTA and since the agreement was signed, is an indication of the potential increase in foreign capital. Of course, we commit the fallacy of composition by extending Mexican results to the Southern Hemisphere in general.

Freer trade will not be without costs. Many industries will not be able to compete without the subsidies and protection they currently enjoy, and will be forced out of business. Some countries will fare worse than others. For example, the U.S.-Mexico agreement will reduce the value of the trading agreements the United States maintains with the countries of Central America and the Caribbean under the Caribbean Basin Initiative. Likewise, if free trade is extended throughout the hemisphere, the value of Mexico's free trade agreement with the United States will be diminished. As more countries enter the free trade area, the biggest losers will be those countries left outside. These same countries may be the weakest economic performers in the area.

The costs of implementing the provisions of a free trade agreement go beyond that of reduced tariff revenues. The costs of implementing environmental standards and requirements could be considerable. The costs of implementing more rigorous intellectual property rights, patent, and copyright provisions could have significant effects on certain Latin American economies and certain industries, such as the pharmaceutical industries, which in many cases do not respect foreign drug property rights provisions. These costs are more difficult to estimate, yet cannot be ignored as factors to consider when weighing the costs and benefits of freer trade.

Finally, there could be costs associated with losing the benefits of trade with other countries of Latin America, especially if the United States admits some countries but does not continuously expand NAFTA to include all Latin American countries. For example, other Latin American countries offer better opportunities for Chile to increase industrial exports and diversify its export base. Depending on Chile's future stance with respect to MERCOSUR, Chile could face higher tariffs on its exports to the MERCOSUR countries by remaining outside of the pact. Although MERCOSUR has not established a common external tariff, it will likely be above the 11 percent that Chile currently maintains. Despite having a better economy and infrastructure, Chile's domestic economy is small and is not necessarily as attractive as Argentina's and Brazil's. Under MERCOSUR, Chile would have, and could offer, access to a much greater market, which would increase Chile's exports and the foreign investment flows to Chile.

CONCLUSION

Certain rules and mechanisms will facilitate the expansion of NAFTA and freer trade and investment in the Americas. These include macroeconomic policies which open trade and capital flows, and the institutional policies which specify standards and requirements to protect investments and lower risks. Implementation of these rules and mechanisms will affect the ability of any one country to meet unmet windows of opportunity in the United States market for fresh fruits and vegetables.

Many Latin American countries have recently implemented macroeconomic policies which have liberalized and expanded trade and investment. These include free market prices, deregulation, and financial reform to provoke capital repatriation. Within the institutional environment, the Latin American countries are in varying stages of reform. The most important institutional mechanisms within the agricultural sector include property rights, entry requirements, licensing of agents and producers, and standards, testing, and inspection requirements.

The agricultural sector, and fresh fruits and vegetables in particular, have great potential to be an important source of economic growth in Latin America for many years into the future. The region possesses vast agricultural resources which are poorly developed and undercapitalized. Historically, tariff and nontariff barriers in the United States and other countries have restricted some agricultural exports. As trade liberalization takes hold in the region, the agricultural sector will benefit.

The recent implementation of macroeconomic mechanisms to free trade indicate that the region is moving rapidly toward the development of regional trading blocks and/or the expansion of NAFTA. Either outcome would have great implications on comparative advantage and future fresh fruit and vegetable exports from Latin America.

In the short run, lower tariffs will provide opportunities to export from Latin America increasing numbers of established fruit and vegetable exports. There could be gains in specific products which have historically faced high tariffs, including asparagus, tomatoes, bell peppers, cucumbers, grapes, melons, and cauliflower. In the long run, the greatest gains from freer trade should come from inceasing flows of investment to Latin America. These investments will be channeled not only into agriculture, but also into roads and ports, telecommunications, energy, and other areas, such as transport, cold storage, and marketing. These all could stimulate the development of more efficient and productive export sectors. Open trading and investment climates will encourage foreign investment and firm productivity. As a result, the structure of comparative advantage will change and potentially open up vast new opportunities for investment.

Table 1. Performance scores on readiness of Latin American countries to join NAFTA

Region/Country	Price Stability	Budget Discipline	External Debt	Currency Stability	Market-oriented Policies	Reliance on Trade Taxes	Functioning Democracy	Average Score	Probability Index
North America	4.3	3.7	4	5	5	4.3	4.3	4.4	
US	5	3	5	5	5	5	5	4.7	
Canada	5	3	4	5	5	5	5	4.6	
Mexico	3	5	3	5	5	3	3	3.9	100% *
Chile	3	5	5	5	5	4	4	4.4	100%
MERCOSUR	1.3	3.8	2.8	4	3.5	2.8	3.5	3.1	
Argentina	0	5	0	3	5	1	4	2.6	59%
Brazil	0	0	2	3	3	5	3	2.3	52%
Paraguay	3	5	5	5	3	2	3	3.7	84%
Uruguay	2	5	4	5	3	3	4	3.7	84%
Andean Group	2.4	4.8	1.8	5	3	3	3.2	3.4	
Bolivia	4	5	0	5	4	4	4	3.7	84%
Colombia	3	5	4	5	4	2	3	3.7	84%
Ecuador	2	5	2	5	3	3	4	3.4	77%
Peru	0	4	0	5	2	2	2	2.1	48%
Venezuela	3	5	3	5	4	4	3	3.9	89%
CACM	2.6	3.8	3	4.2	1.8	1	2.8	2.7	
Costa Rica	3	4	4	5	3	0	4	3.3	75%
El Salvador	4	5	5	5	2	2	3	3.7	84%
Guatemala	3	5	4	3	1	0	2	2.6	59%
Honduras	3	3	2	5	2	0	3	2.6	59%
Nicaragua	0	2	0	3	1	3	2	1.6	36%
CARICOM	3.6	3.6	3.8	5	2.8	2.4	4.4	3.7	
Bahamas	4	4	5	5	3	0	4	3.6	82%
Barbados	4	4	5	5	3	3	5	4.1	93%
Guyana	3	0	0	5	2	3	4	2.4	55%
Jamaica	3	5	4	5	3	2	4	3.7	84%
Trinidad and Tobago	4	5	5	5	3	4	5	4.4	100%

Note: * Mexico is given a 100 percent probability because it is already a NAFTA signatory.
SOURCE: G.C. Hufbauer and J.J. Schott, *Western Hemisphere Economic Integration*, Institute for International Economics, Washington (1994), Chapters 5 and 6.

Table 2. Key macroeconomic reforms essential for Latin American entry into NAFTA

Fiscal Policy

- Restraint in central government spending to reduce public sector deficits
- Tax reform to reduce tax evasion and make the tax system both more equitable and credible
- Alignment of public prices to free-market levels
- Deregulation and privatization of state-run enterprises

Monetary Policy

- Financial reform to provoke capital repatriation and financial intermediation
- Stronger private financial savings via:
  - Financial instruments with longer maturities and flexible rates
  - Regulatory framework to modernize financial intermediaries
  - Privatization of commercial banks

Trade and Investment Policy

- Debt reduction
- Lowering of tariffs and elimination of nontariff barriers
- Elimination of export subsidies, export quotas, and content requirements
- Liberal foreign investment climate
  - Foreign ownership of domestic enterprises
  - Ability to introduce new industries
- No restrictions on profit repatriation

Long-term Development Policies

- Increased rates of savings and investment
- Improvements in technology
- Updated production capacity and organization
- Elimination of poverty

Table 3. Tariff structure comparison of fruit and vegetable products

	EEC	Japan	US
		(Percent)	
VEGETABLES			
Fresh and Frozen	7	9	8
Processed	15	18	11
FRUIT			
Fresh and Frozen	8	22	1
Processed	17	22	20

SOURCE: Estrategia Comercial Chilena para la Decada del 90.

APPENDIX 1

North-South American Regional Trade Agreements

Trade Bloc	Countries	In Force	Comments
North American Free Trade Agreement (NAFTA)	Mexico, the United States, and Canada	1994	Tariff reduction following ratification. Thousands of products enjoy gradual 1 to 15-year reductions.
Andean Pact	Bolivia, Colombia, Ecuador, and Venezuela	1994	Customs union since 1994. Peru has excluded itself from this agreement.
MERCOSUR	Argentina, Brazil, Uruguay, and Paraguay	1995	Free trade agreement in force, and customs union by 1995, although tensions persist between Argentina and Brazil.
Group of Three (G-3)	Mexico, Colombia, and Venezuela	1994	Trade liberalization agreement in ten years, starting January 1, 1994.
Central American Common Market (MCCA)	El Salvador, Honduras, Nicaragua, Costa Rica, and Guatemala	To be defined	Free trade agreement and customs union under negotiation.
Venezuela/MCCA	Venezuela and MCCA countries	1992	Venezuela unilaterally opened up its markets to the MCCA countries.
Venezuela/Caribbean Economic Community (CARICOM)	Venezuela and English-speaking Caribbean countries	1992	Venezuela unilaterally opened up its markets to the CARICOM member countries. One hundred fifty-seven CARICOM products enjoy free access to Venezuela and an additional 162 receive preferential treatment.

Appendix 1. Continued

Trade Bloc	Countries	In Force	Comments
Venezuela-Colombia/MCAA	Venezuela and Colombia with the MCAA countries	1993	Trade and investment agreement in force.
CARICOM/Cuba		1993	Trade and technical cooperation agreement in livestock, fishing, and agriculture programs.
Chile/United States		To be defined	Negotiations will start following NAFTA ratification.
Mexico/Chile		1992	Economic complementarity agreement with a 2.5% annual tariff reduction, to reach zero by 1996. Exceptions: oil and related products, glass, ceramics, animal fats, textiles, and timber.
Chile/Argentina		1991	Economic complementarity agreement in force.
Chile/Venezuela		1993	Free trade agreement scheduled for 1997.
Mexico/MCCA		1996	Framework agreement for free trade. MCCA countries must negotiate bilaterally with Mexico.
Mexico/Argentina		1986	Economic complementarity agreement in force.
Colombia/Ecuador		1992	Bilateral free trade agreement in force.
Colombia/Bolivia		1992	Bilateral free trade agreement in force.
Bolivia/Peru		1992	Bilateral free trade agreement in force, except for sales of Bolivian soybean and sunflower oil to Peru, with an 8.5% tariff.

Appendix 1. Continued

Trade Bloc	Countries	In Force	Comments
Bolivia/Uruguay		1991	Economic complementarity agreement in force.
Mexico/Bolivia		1998	Bilateral free trade agreement under negotiation.
Mexico/Costa Rica		1992	Bilateral free trade agreement in force.
Chile/Uruguay		1985	Economic complementarity agreement in force.
Argentina/Colombia		1988	Economic complementarity agreement in force.
Argentina/Venezuela		1986	Economic complementarity agreement and tariff-preferences agreement with broadened scope since 1993.
Argentina/Bolivia		1989	Economic complementarity agreement in force.
Colombia/MCCA		To be defined	Free trade agreement under negotiation.
Ecuador/Venezuela		1993	Free trade agreement in force.
Ecuador/Peru		1993	Free trade agreement in force, including 500 tariff items.
Ecuador/Bolivia		1992	Fee trade agreement in force.
Colombia/Peru		1992	Free trade agreement in force, including 115 tariff items.
Venezuela/Peru		1992	Partial free trade agreement in force.

Appendix 1. Continued

Trade Bloc	Countries	In Force	Comments
Chile/Colombia		1994	Economic complementarity agreement under negotiation.
Chile/Brazil		To be defined	Bilateral economic cooperation agreement prior to free trade agreement.
Bolivia/Chile		1993	Economic complementarity agreement in force.
Venezuela/Costa Rica		To be defined	Free trade agreement framework.

SOURCE: "*Regional Moves*," America Economica, Special Issue, 1993-1994.

APPENDIX 2
NAFTA Microeconomic Requirements

I. Investment

A. Nondiscriminatory and Minimum Standards of Treatment

Each country will treat NAFTA investors and their investments no less favorably than its own investors—national treatment—and investors of other countries—most-favored-nation treatment.

B. Performance Requirements

No NAFTA country may impose specified "performance requirements" in connection with any investments in its territory, namely specified export levels, minimum domestic content, preferences for domestic sourcing, trade balancing, technology transfer, or product mandating. However, these disciplines do not apply to any NAFTA country's government procurement, export promotion, or foreign aid activities.

C. Transfers

NAFTA investors will be able to convert local currency into foreign currency at the prevailing market rate of exchange for earnings, proceeds of a sale, loan repayments, or other transactions associated with an investment. Each NAFTA country will ensure that such foreign currency may be freely transferred.

D. Expropriation

No NAFTA country may directly or indirectly expropriate investments of NAFTA investors except for a public purpose, on a nondiscriminatory basis, and in accordance with principles of due process of law. Compensation to the investor must be paid without delay at the fair market value of the expropriated investment, plus any applicable interest.

E. Dispute Settlement

This section sets out a detailed mechanism for the resolution of investment disputes involving a breach of the NAFTA investment rules by the host country. A NAFTA investor, at its option, may seek either monetary damages through binding investor-state arbitration or the remedies that are available in the host country's domestic courts.

F. Country-Specific Commitments and Exceptions

NAFTA includes explicit, country-specific liberalization commitments and exceptions to the national treatment, MFN, and performance requirement rules. In the case of Mexico, these exceptions take into account constitutional requirements reserving certain activities to the Mexican State. Each country will specify exceptions for state and provincial measures within two years. Exceptions may not be made more restrictive and, if liberalized, may not subsequently be made more restrictive. However, a few sectors, such as basic telecommunications, social services, and maritime services, are not subject to this constraint.

Canada may review acquisitions as provided in the Canada-U.S. FTA. Mexico may review acquisitions with an initial threshold of $25 million phased up to $150 million in the tenth year after the Agreement goes into effect. Threshold levels will be indexed.

G. Exceptions

The investment provisions do not apply to government procurement and subsidies. Other provisions of the Agreement address exceptions related to national security and to Canada's cultural industries.

H. Investment and the Environment

The NAFTA provides that no country should lower its environmental standards to attract an investment and that the countries will consult on the observance of this provision. The Agreement also specifies that a country may take action consistent with the NAFTA's investment provisions to protect its environment.

II. Financial Services

A. Commercial Presence and Cross-Border Services

Under the agreement, financial service providers of a NAFTA country may establish in any other NAFTA country banking, insurance and securities operations as well as other types of financial services. Each country must permit its residents to purchase financial services in the territory of another NAFTA country. In addition, a country may not impose new restrictions on the cross-border provision of financial services in a sector, unless the country has exempted that sector from this obligation.

B. Non-Discriminatory Treatment

Each country will provide both national treatment, including treatment respecting competitive opportunities, and most-favored-nation treatment to other NAFTA financial service providers operating in its territory.

C. Mexico Specific Commitments

Mexico will permit financial firms organized under the laws of another NAFTA country to establish financial institutions in Mexico, subject to certain market share limits that will apply during a transition period ending by the year 2000. Thereafter, temporary safeguard provisions may be applicable in the banking and securities sectors.

III. Intellectual Property

Building on the work done in the GATT and various international intellectual property treaties, NAFTA establishes a high level of obligations respecting intellectual property. Each country will provide adequate and effective protection of intellectual property rights on the basis of national treatment and will provide effective enforcement of these rights against infringement, both internally and at the border.

A. Copyright

For copyright, the Agreement's obligations include several requirements:
- to protect computer programs as literary works and databases as compilations;
- to provide rental rights for computer programs and sound recordings;
- to provide a term of protection of at least 50 years for sound recordings.

B. Patents

NAFTA provides protection for inventions by requiring each country:
- to provide product and process patents for virtually all types of inventions, including pharmaceuticals and agricultural chemicals;
- to eliminate any special regimes for particular product categories, any special provisions for acquisition of patent rights and any discrimination in the availability and enjoyment of patent rights made available locally and abroad;
- to provide patent owners the opportunity to obtain product patent protection for pharmaceutical and agricultural chemical inventions for which product patents were previously unavailable.

C. Other Intellectual Property Rights

This section also provides rules for protecting:
- service marks to the same extent as trademarks;
- encrypted satellite signals against illegal use;
- trade secrets generally, as well as for protecting from disclosure by the government test data submitted by firms regarding the safety and efficacy of pharmaceutical and agrichemical products;
- integrated circuits, both directly and in goods that incorporate them;
- geographical indications so as to avoid misleading the public, while protecting trademark owners.

D. Rules of Origin

Rules of Origin are one of the most complex areas of the NAFTA treaty, and present challenges to the expansion of NAFTA because many countries have established different rules of origin within other trading pacts.

Within NAFTA, the rules of origin specify that goods originate in North America if they are wholly North American. Goods containing nonregional materials are also considered to be North American if the nonregional materials are sufficiently transformed in the NAFTA region so as to undergo a specified change in tariff classification. In some cases, goods must include a specificed percentage of North American content in addition to meeting the tariff classification requirement. The rules of origin section also contains a provision similar to one in the Canada-U.S. Free Trade Agreement (FTA) that allows goods to be treated as originating when the finished good is specifically named in the same tariff subheading as its parts and it meets the required value content test. Regional value content may be calculated using either the "transaction-value" or the "net-cost" method.

IV. Monopolies and State Enterprises

State Enterprises: The Agreement requires any enterprise owned or controlled by a federal, provincial, or state government to act in a manner consistent with that country's NAFTA obligations when exercising regulatory, administrative or other governmental authority, such as the granting of licenses.

Monopolies: NAFTA imposes certain additional disciplines on current and future federal government-owned monopolies and on any privately-owned monopoly that a NAFTA country may designate in the future. When buying or selling a monopoly good or service, the monopoly must follow commercial considerations, consistent with the terms of its government mandate, and must not discriminate against goods or businesses of the other NAFTA countries. NAFTA provides that each country must ensure that such monopolies do not use their monopoly positions to engage in anticompetitive practices in non-monopoly markets in that country's territory.

V. Environmental Provisions

The three NAFTA countries have committed in the NAFTA to implementing the Agreement in a manner consistent with environmental protection and to promoting sustainable development. Specific provisions throughout the Agreement build upon these commitments. For example:

- The trade obligations of the NAFTA countries under specified international environmental agreements regarding endangered species, ozone-depleting substances, and hazardous wastes will take precedence over NAFTA provisions, subject to a requirement to minimize inconsistency with the NAFTA. This ensures that the NAFTA will not diminish a country's right to take action under these environmental agreements.

- The Agreement affirms the right of each country to choose the level of protection of human, animal, or plant life or health or of environmental protection that it considers appropriate.

- NAFTA also makes clear that each country may maintain and adopt standards of sanitary and phytosanitary measures, including those more stringent than international standards, to secure its chosen level of protection

VI. Trade

A. Government Procurement

The Agreement opens a significant portion of the government procurement market in each NAFTA country on a nondiscriminatory basis to suppliers from the other NAFTA countries for goods, services and construction services.

B. Cross-Border Trade in Services

The cross-border trade in services provisions establish a set of basic rules and obligations to facilitate trade in services between the three countries.

C. National Treatment

The Agreement extends to services the basic obligation of national treatment, which has long been applied to goods through the GATT and other trade agreements.

D. Most-Favored-Nation Treatment

The Agreement also applies another basic GATT obligation to services: that of most-favored-nation treatment. This rule requires each NAFTA country to treat service providers of the other NAFTA countries no less favorably than it treats service providers of any other country in like circumstances.

E. Local Presence

Under the Agreement, a NAFTA country may not require a service provider of another NAFTA country to establish or maintain a residence, representative office, branch or any other form of enterprise in its territory as a condition for the provision of a service.

F. Reservations

Each NAFTA country will be able to keep certain current laws and other measures that do not comply with the rules and obligations described above. Such federal, state and provincial measures will be listed in the Agreement. Each NAFTA country will have up to two years to complete the list of state and provincial measures of this kind. All such measures currently in force at the municipal and other local government level may be retained. Each NAFTA country may renew or amend its nonconforming measures provided that the renewal or amendment does not make a measure more inconsistent with the rules and obligations described above plus regulations dealing with:

- Nondiscriminatory Quantitative Restrictions
- Licensing and Certification
- Denial of Benefits
- Exclusions

APPENDIX 3

Overview of Trade Liberalization Passages

I. Introduction

Regional economic integration has been a policy objective of most, if not all, Latin American governments for many years. In the past, none of the many bilateral and multilateral trading arrangements have fulfilled their promise. More recently, however, there has been renewed interest in trade liberalization and strengthened regional economic ties. Latin American governments are instituting wide-ranging economic liberalization and structural reforms, and export promotion is viewed as a key vehicle of growth. Some of the most promising arrangements include the Southern Cone Common Market (MERCOSUR) and the Andean Group. These trading schemes are comparable to the European Community in its earliest stages; for example, the Andean Pact aims to create a customs union and common market while MERCOSUR is starting sectoral integration (e.g. in capital goods, iron and steel, and vehicles) as did the European Coal and Steel Community.

Some of the obstacles to Latin American economic integration include problems of multiple, overlapping commitments (for Mexico, Colombia, and Venezuela in particular), questions of economic sovereignty, national standards, and government nontariff barriers. (See Appendix 1 for a summary of trading pacts and agreements pertaining to intraregional trade in Latin America.) In addition, the size of many Latin American markets is quite small, with limited opportunity for trade growth. (See Appendix 4 for intraregional trade figures for each Latin American country.) Given the small degree of inter-Latin American trade relative to trade with the rest of the world, Latin American regional integration schemes could serve as useful springboards or corollary agreements to integration with the United States and other large market economies.[14]

The United States is becoming a major force in Latin American regional integration. Free trade agreements beyond NAFTA, such as with Chile, are being informally discussed. The United States already has a number of trade promotion initiatives in Latin America, such as the Caribbean Basin Initiative and the Enterprise for the Americas Initiative. However, more formal trade arrangements with Latin America will likely depend on NAFTA's success.

II. North American Free Trade Agreement (NAFTA)

NAFTA provisions provide for the phased elimination of tariff and most nontariff barriers over a relatively short transition period. NAFTA also established a framework for dispute settlements, common rules of origin, and administrative procedures, and addressed key social issues such as labor standards, wages, and the environment.

NAFTA will eliminate immediately, or over a period not exceeding 15 years, all tariffs, quotas, and licenses that act as barriers to horticulture. The reduction of tariff barriers with Mexico will not only increase Mexican trade flows to the United States for some products but, in the cases of oranges and tomatoes, NAFTA may help to increase U.S. exports to Mexico.

In addition, the United States and Mexico are actively discussing possible means for enhancing the exchange of standards information and increasing transparency in the overall process. Recently, to further this exchange of information and to avoid trade disruptions, the United States and Mexico established several committees to discuss sanitary and phytosanitary issues in agricultural trade between the two nations.

The impact of NAFTA on Latin America as a whole depends partly on the magnitude of trade liberalization actually achieved with NAFTA and on the degree of trade creation versus trade diversion.

III. The Enterprise For The Americas Initiative

Trade is the centerpiece of this initiative and the ultimate goal is the creation of a Western Hemispheric free trade area. The United States has negotiated bilateral framework agreements on trade and investment with interested countries in the region covering the benefits of open trade and investment, the increasing importance of services in the economy, the need for adequate protection of intellectual property rights, the importance of observing and promoting internationally recognized workers' rights, and the desirability of effectively resolving trade and investment problems.[15] The initiative provides for sectoral loan programs, multilateral investment funds, and debt reduction programs. In addition, each framework pact established a Council on Trade and Investment which acts as a bilateral consultative authority between the United States and each signatory nation.

IV. Caribbean Basin Initiative (CBI)

In 1983, the Caribbean Basin Initiative established that most countries in the Caribbean and Central American region were eligible to apply for duty-free trade and other benefits for almost all exports to the United States. In 1990, the Caribbean Basin Economic Recovery Expansion Act was signed into law, making the CBI permanent. At the time of the original signing, there were 27 countries eligible for such benefits, opening large possibilities for trade flows into the U.S. markets. This act created the first major need for U.S. market information for nontraditional agricultural products.

V. The Andean Trade Preference Act (ATPA)

The Andean Trade Preference Act went into effect in 1991 and is not scheduled to expire until 2001. The ATPA is a unilateral trade program similar to the CBI. It is designed to promote economic development in the Andean countries through private initiative. One goal of the act was to diversify these countries' export bases and to gain broader access to U.S. markets. Through this act, increased opportunities should exist for Andean countries to export to the United States. Fresh cut flowers, pineapple, tobacco, raspberries, and tomatoes enter duty-free, while passion fruit, pitaya, papaya, mangoes, and grapes offer short-term export potential.[16]

VI. The Southern Cone Common Market (MERCOSUR—Mercado Comun Del Sur)

Hailed initially as the first step towards Latin American Hemispheric integration, MERCOSUR has achieved mixed results in its goal of creating a common market among Chile, Argentina, Paraguay, and Uruguay by December 1995. MERCOSUR includes reductions in tariffs, phasing out of import quotas and nonquantitative trade restrictions, coordination of macroeconomic policies, and development of accords for specific economic sectors to optimize the use of mutual resources. Tariffs among member nations have already been reduced an average of 68 percent. United States reaction to MERCOSUR is lukewarm because the arrangement could lead to trade diversions through high external tariffs for third parties and nonquantitative trade restrictions.

VII. Andean Group

The Andean Pact was signed in 1969 by Bolivia, Colombia, Ecuador, Peru, and Chile; Venezuela joined in 1973 and Chile dropped out in 1976. The Andean Group has eliminated tariffs on 3,000 items and some degree of tariff harmonization was developed through a minimum common external tariff. The Andean nations have emphasized common policies on foreign direct investment and technology transfer to deter a concentration of high-value added industry in the more advanced countries. In 1990, the members signed the La Paz Act, which will create a true regional free trade area, and they have since agreed to define common external tariffs and attempt to harmonize macroeconomic policies.

In 1990, the United States agreed to give unilateral tariff preferences to goods exported from Bolivia, Ecuador, Peru, and Colombia, but only 67 products, with an export value of $27 million, were provided GSP status.

VIII. Central American Common Market (CACM)

The Central American Common Market was established in 1960, collapsed in the late 1970s, and regrouped in the 1980s. The members—Nicaragua, Guatemala, Costa Rica, Honduras, El Salvador, and Panama—represent all of the countries in the subregion except Belize. The CACM most recently has agreed to liberalize regional trade in basic grains and all crude agricultural products.

The CACM has entered into separate free trade agreements with Mexico and Venezuela which provide for the elimination of tariffs and/or nontariff barriers. The United States has stated that it prefers to negotiate free trade agreements with each CACM member individually.

IX. Caribbean Economic Community (CARICOM)

The CARICOM was established in 1973 with the goal of forming a Caribbean Common Market and monetary union. Its members are Antigua and Barbuda, The Bahamas, Barbados, Belize, Dominica, Grenada, Guyana, Jamaica, Monserrat, St. Kitts and Nevis, St. Lucia, St. Vincent, Trinidad and Tobago. On three occasions, CARICOM has delayed the deadline to create a customs union, and intraregional trade flows have been erratic.

APPENDIX 4

Summary of Intraregional Exports in Latin America (1992)

(In Millions of U.S. dollars)

	Intraregional Exports (FOB)	Total Exports (FOB)	Intraregional as % of Total
Argentina	3,918	12,235	32%
Bolivia (1)	296	765	39%
Brazil	7,628	36,207	21%
Chile	1,623	9,921	16%
Colombia (2)	1,307	7,140	18%
Ecuador	402	3,008	13%
Mexico	1,368	27,208	5%
Paraguay	312	657	47%
Peru	735	3,300	22%
Uruguay	672	1,620	41%
Venezuela	1,200	13,860	9%
Imports (FOB)	19,461	115,921	

SOURCE: Latin American Integration Association (ALADI)

Appendix 4. Continued

Destination Origin	Argentina	Bolivia	Brazil	Chile	Colombia	Ecuador	Mexico	Paraguay	Peru	Uruguay	Venezuela
Argentina	N/A	161	1,671	581	105	70	234	272	236	384	204
Bolivia (1)	154	N/A	15	18	25	4	7	1	61	1	10
Brazil	3,070	334	N/A	930	347	135	1,111	541	199	517	444
Chile	460	155	452	N/A	75	64	90	42	175	35	75
Colombia (2)	76	15	58	102	N/A	156	69	1	270	1	559
Ecuador	28	1	13	152	63	N/A	33	0	100	0	12
Mexico	177	8	427	151	217	61	N/A	11	62	58	196
Paraguay	64	2	171	47	1	1	2	N/A	5	11	8
Peru	84	27	157	61	79	31	175	1	N/A	3	117
Uruguay	250	3	284	50	8	2	42	10	18	N/A	5
Venezuela	20	1	258	113	471	42	159	3	112	21	N/A
Intraregional Imports (FOB)	4,383	707	3,506	2,205	1,391	566	1,922	882	1,238	1,031	1,630

ENDNOTES

1. Depending on the supply elasticity.

2. U.S. Department of Commerce Trade Database for average annual imports, 1989 - 1992.

3. Gary Clyde Haufbaeur and Jeffrey J. Schott, *North American Free Trade: Issues and Recommendations*, p. 38.

4. Gary Clyde Hufbauer and Jeffrey J. Schott, *Western Hemisphere Economic Integration*, Institute for International Economics, Washington (1994), Chapters 5 and 6.

5. This argument was put forth in Whalley, "Expanding the North American Free Trade Agreement," Institute for Policy Reform Working Paper (1992).

6. Taken from analysis in Sigler, "Expansion of NAFTA and Free Trade in Latin America–Prospects for the Future," 1994 (unpublished).

7. For a thorough discussion of the "readiness" of Latin American countries to join NAFTA, see Gary Clyde Hufbauer and Jeffrey J. Schott, *Western Hemisphere Economic Integration*, Institute for International Economics, Washington (1994), Chapters 5 and 6.

8. "Chile—Political and Economic Briefing Paper," National Directorate for Communications, Government of Chile, August 1993, p. 1.

9. Both Mexico and Canada conduct between two-thirds and three-quarters of their trade with the United States, and the United States conducts about one-quarter of its trade with the two of them combined. The combined intraregional trade of the three countries represents about 40 percent of their total exports.

10. John Whalley, "Expanding the North American Free Trade Agreement," Working Paper Series, Institute for Policy Reform, Sept. 1992.

11. Formally, the mathematical definitions of trade creation and diversion.

12. See J. Bhagwati "Regionalism and Multilateralism: An Overview," World Bank and CEPR Conference on New Dimensions in Regional Integration, Washington, D.C., April 1992.

13. This view is supported by Roberta Cook et al. in *NAFTA: Effects on Agriculture, Volume IV, Fruits and Vegetable Issues,* American Farm Bureau Research Foundation, 1991.

14. By comparison, intraregional trade in the NAFTA region is about 40 percent of total regional trade. See Hufbauer and Schott, "Free Trade Areas, the Enterprise for the America's Initiative, and the Multilateral Trading System," in Colin Bradford, ed., *Strategic Options for Latin America in the Future*, p. 259.

15. Hufbauer and Schott, “Free Trade Areas, the Enterprise for the America's Initiative, and the Multilateral Trading System,” in Colin Bradford, ed., *Strategic Options for Latin America in the Future.*

16. Thomas E. Wilde, Jr. and Maria de la Guardia, "Agribusiness Trade in Colombia Offers More than Just Coffee and Beans," *Business America*, Latin American/Caribbean Development Center, United States Department of Commerce, September 21, 1992.

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