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The Evolution of Trade Treaties and Trade Creation

Lessons for Latin America

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Latin American countries can avoid trade diversion in their regional trade agreements through GATT-plus trade liberalization.

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Summary findings

Rajapatirana examines the main distinctions between trade liberalization under the General Agreement on Tariffs and Trade (GATT) and under regional trading agreements. Under the GATT, trade liberalization is based on the most-favored-nation principle. Under regional trade agreements, it is based on preferential trade.

Establishing regional trade agreements does not necessarily lead to greater regional integration. The European Economic Community has been an exception, and with greater integration, regional trade has grown steadily. The Association of South East Asian Nations (ASEAN) has been a weak association, but trade among ASEAN members has increased rapidly because member countries have undertaken multilateral trade liberalization.

The efforts of Latin American countries to create regional trade associations in the 1960s, based on protectionist policies, reduced trade not only regionally, but with the rest of the world. In contrast, the Latin American regional trading agreements of the 1980s and 1990s have liberalized trade among the groups.

Proper regional trading agreements must conform to Article XXIV of the GATT, but nearly all the countries that have created regional integration schemes have not followed it. These regional trading agreements have not increased protection, but neither has there been across-the-board trade liberalization.

Regional trading agreements carry with them the danger of trade diversion (when imports that used to come from third countries at lower prices become costlier because of preferential access granted to a higher-cost regional source).

How can Latin American countries reduce trade diversion in their regional trading agreements?

- Keep protection low in the first place.
- Have open regional trade associations (so that it is easy for new partners to join).
- Continue liberalizing trade with the rest of the world, following the most-favored-nation principle.
- Establish common markets rather than free trade areas (because rules of origin create new barriers, including bureaucracies).
- Coordinate regulatory and competition policies. Eliminate laws that limit competition and adopt common external tariffs.
- Improve roads, ports, and means of communications.

This paper—a product of the Advisory Group, Latin America and the Caribbean Technical Department—is part of a larger effort to disseminate lessons about policy and institutional reform that are relevant to the region. Copies of the paper are available free from the World Bank, 1818 H Street NW, Washington, DC 20433. Please contact Joy Troncoso, room I8-314, extension 37826 (31 pages). October 1994.

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by

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The Evolution of Trade Treaties and Trade Creation: Lessons for Latin America

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The Evolution of Trade Treaties and Trade Creation: Lessons for Latin America

I. Introduction

Two parallel movements have dominated trade treaty making in the 1980s and the 1990s. These are the initiation and the successful negotiation of the Uruguay Round of multilateral trade negotiations and the resurgence (or in some cases the genesis) of regional trade treaties or agreements. Not surprisingly the initiation and progress of both types of treaties have been closely related. They lead to issues related to the evolution of these agreements and the potential for trade creation.

Trade treaties have a long history and a wide variety throughout the world. The broadest possible way to classify them is to distinguish between those that lead to equal treatment of all on a multilateral basis and those that are preferential treaties which bestow special access into the markets of member countries. This classification is based on the principle that is a cornerstone of post-war trading arrangements-- the most favored nation (MFN) principle. Simply put, MFN means that any access given to the market of a country has to be extended to all other members. The General Agreement on Tariffs and Trade (GATT) is based on this principle and the successor to GATT, the World Trade Organization (WTO), will be based even more strongly on this principle. Any other trade treaty between two or more member countries is a departure from that principle if it bestows access to each other's market that is not automatically granted to all others. Preferential trade agreements, whether they be free trade areas, customs unions, or economic unions, are thus departures from the MFN principle. There is another important distinction between the GATT and any other treaty. That is, all other trade treaties have to be recognized within the GATT agreement. GATT is unique. Membership in GATT automatically creates a treaty with all others who are members of the world trading system. Hence the term "general agreement." Non-members, such as the former Soviet Union, were excluded from MFN access in the past. In contrast, the other trade treaties are not general or multilateral trade arrangements. They are not unique in the sense of being based on MFN. They can and do take many shapes and forms.

This paper examines the main distinctions between the GATT and other agreements henceforth referred to as regional trade agreements (RTAs), the evolution of the main agreements in Europe, Asia, and Latin America, to see whether there is an inexorable pattern or logic to their evolution. It then analyses, in the broadest possible terms, the effects of the RTAs to determine their advantages and disadvantages from the perspective of both the international economy and an individual group of countries. The paper notes that MFN based trade is first best and that the departures from that principle could be beneficial only to the extent that they lead to or GATT-plus trade, which implies that more net trade is created than possible under MFN trade liberalization on a unilateral basis. It recognizes the inherent dangers that lurk outside the MFN framework, and it delineates the possible ways of minimizing these risks. A final section gives the main conclusions.

II. GATT and Regional Trade Arrangements

There is a long history of trade treaties in the world. This includes treaties such as the Zollverein treaty that created free trade among the German states in 1832, the Cobden-Chevalier treaty of 1870 that led to free trade between Britain and France, and the commercial treaty between Spain and Portugal of 1893 which provided for reciprocal free entry. After the Second World War GATT was born out of the Treaty of Havana of 1947. GATT became one of the key elements for establishing a stable international economic order as it provided the rules and disciplines for carrying out international trade.

Under the aegis of GATT there has been a significant reduction of trade barriers through several rounds of multilateral trade negotiations. Before the GATT came into existence the average tariff protection among advanced industrialized countries was above

100%. By 1993, after seven rounds of multilateral trade negotiations, the average tariff had fallen to 5%.[1] This liberalization process was accompanied by huge increases in trade flows. Between 1950 and 1970 international trade grew at a rate of 8 percent annually, outpacing the growth of world output.[2] During the 1980s world trade grew at annual rates of between 6 and 9 percent.[3] Trade in manufactures was the most dynamic. In 1965 the proportion of world trade represented by industrial goods was 54 percent; by 1989, it had reached 73 percent.[4]

GATT Negotiating Rounds

Round	Dates	Number of Countries	Value of Trade Covered (US$)
Geneva	1947	23	10 billion
Annecy	1949	33	n.a.
Torquay	1950	34	n.a.
Geneva	1956	22	2.5 billion
Dillon	1961	45	4.9 billion
Kennedy	1962	48	40 billion
Tokyo	1973	99	155 billion
Uruguay	1986	124	755 billion

Source: Quoted in Jagdish Bhagwati. The World Trading System at Risk. Princeton, New Jersey: Princeton University Press. 1991. p. 8 and, GATT. Focus. GATT Newsletter. No.107. Special Issue. May 1994. pp. 1, 8.

Regional trade agreements were accommodated within GATT, although this actually meant a departure from the MFN principle.[5] They were initially allowed because they could constitute a movement toward achieving freer trade.[6] The creation of regional trade

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[1] Sebastian Edwards. "Trade and Industrial Policy Reform in Latin America." Cambridge, MA: (1994) NBER Working Paper Series. No. 4772. p. 42.

[2] World Bank. World Development Report. 1987. Washington, D.C.: Oxford University Press, 1987. p. 14.

[3] Diana Brand. "Regional Bloc Formation and World Trade," in Intereconomics. November/December 1992. Vol. 27. No. 6. p. 274.

[4] Ibid. p. 277.

[5] Jagdish Bhagwati. The World Trading System at Risk. Princeton, New Jersey: Princeton University Press, 1991. p. 69.

[6] Kenneth W. Dam. The GATT: Law and the International Economic Organization. Chicago: University of Chicago Press, 1970. p. 19.

agreements was sanctioned through Article XXIV of GATT which establishes the conditions for the existence of customs unions and free trade areas. In spite of the initial attempt to close all possible loopholes to avoid RTAs of less than 100 percent preferences (i.e., covering all sectors), the ambiguities of Article XXIV, as well as political pressures, combined to allow RTAs of less than 100 percent preferences - a substantial departure from the MFN principle. Developing countries sought special and differential treatment for the establishment of regional trade arrangements among themselves. The incorporation of the *Enabling Clause* in 1979 as a result of the Tokyo Round established the principles for the creation of RTAs among developing countries. The *Enabling Clause* allows these countries to establish "regional and global preferential arrangements among developing countries not conforming to Article XXIV."[7] From past experiences it seems that RTAs need to operate under a very specific set of conditions in order to reach higher levels of trade than those that could be achieved under pure MFN and what has been called GATT-plus trade creation.

The main provisions of article XXIV minimize the departure from MFN through the requirement that RTAs must be based on the reduction of protection and that this reduction should be across the board (i.e., 100% preference). These have been ignored with impunity. As Kenneth Dam observed more than twenty years ago, the ambiguity of the article, the lack of strong dispute settlement power within GATT, and political realities had made these provisions somewhat of a dead letter.[8] In addition, developing countries received exemption from the provisions. More recently, the centrifugal forces of Europe and the US changed stance towards the departure from the MFN principle have led to the greater accommodation of the regional trading agreements. Indeed, the Latin American continent saw the virtual proliferation of agreements ranging from the resurrection of the Andean group to the formation of Mercosur and the North American Free Trade Agreement (NAFTA). Sixteen framework agreements have been signed between the US and 31 Latin American countries

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[7] John Whalley. "Non-Discriminatory Discrimination: Special and Differential Treatment under the GATT for Developing Countries," in The Economic Journal. No. 100. December 1990. p. 1321.

[8] Kenneth Dam The GATT: Law and the International Economic Organization. Chicago: Univ. of Chicago Press. 1970.

towards the creation of a Western Hemisphere Free Trade Agreement. These agreements aim to facilitate trade and investment through consultative mechanisms and could be the basis for an enlargement of NAFTA. Other agreements such as the Group of Three, among Colombia, Mexico and Venezuela, the associated status that could be extended to Chile under NAFTA or the agreement between Chile and Mexico, all point to the impetus given to RTAs in the region. Moreover, the commitment of foreign ministries to forge trade agreements as a part of the regional political unity has meant that the evaluation of economic benefits and the difficulties of implementing agreements without adequate policy consistency among member countries took a back seat to political objectives. In the event it becomes even more important to consider the ways in which the benefits from these agreements could be realized and the costs of trade diversion minimized.

III. Trade Treaties as an Evolutionary Process

Following the classification between GATT and the RTAs it is useful to consider whether there is a distinct evolutionary process at work for these two types of trade treaties.

The evolutionary process insofar as the GATT is concerned seems clear enough. GATT has evolved from restricted trade to more open trade given the built-in tendency for trade to become increasingly free under the GATT. The internal logic of MFN involves both a reduction of costs and greater competition. In practice this has resulted in reduced protection and the increased coverage of world trade under MFN. Any trade liberalization is extended to all members of GATT and the reduction of tariffs is bound. However, since RTAs are included within the GATT framework, it seems that while overall trade has been liberalized, more trade has come under regional arrangements. This appearance is deceptive. While RTAs have proliferated, trade under RTAs has not. There has been much greater trade expansion under MFN basis than under preferential trade. Thus, overall trade growth has clearly exceeded the growth in preferential trade. It is bound to increase more in the future given that the rules of international trade discipline are being made more transparent and the processes for dispute settlement more effective under WTO than has been the case in the GATT. Moreover, article XXIV has been given more bite with the definition of the transition arrangements. Also, the method of calculating average tariff prior to reducing protection under an RTA has been defined clearly.[9] GATT-sanctioned trade treaties are more prone to move to increasingly less protective trade on a multilateral basis.

On the other hand, RTAs do not seem to inexorably follow a trade creating pattern as a general proposition. It is sometimes assumed that RTAs will follow an evolutionary process that will result in the increase of trade. This gradual evolution to free trade has not been the rule. Article XXIV allows a transition period to adjust to more liberal trade, however, most RTAs do not lead to total liberalization. In the past RTAs notified to GATT under Article XXIV have not been specific about transition periods and they have excluded some sectors from preferential access.

The motive for the attempt at integration in Latin America came from the idea that preferential treatment would expand trade and make it easier to reach economies of scale in industrial production. This was very much the philosophy of the Economic Commission for Latin America during the 1960s. However, past Latin American trade arrangements led to very limited trade expansion among the regional groups given that the treaties incorporated a protectionist approach and involved strong discriminatory practices and complex regulations. The expansion of trade would not have been net trade creating given the protectionist stances of the member countries. These RTAs also represented a clear departure from the MFN principle and put in jeopardy the possibilities of increasing trade at the regional and the international levels. They ended up reducing trade among the regional partners and isolating these countries from the international economy. There was hardly any participation of Latin American countries in the earlier GATT rounds. Some were not even members. For

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[9] This is only for free trade areas. It does not apply to customs unions.

example, Mexico joined only in 1986, Bolivia and Costa Rica in 1989, while El Salvador, Guatemala, Honduras, Paraguay, and Venezuela negotiated their accession after 1991.

The European Experience

The apparent success of the European Economic Community (EC) inspired Latin American countries towards regional integration.

The EC was created with the initial support of the US and "was stimulated by European oligopolies"[10] that saw in a European market an opportunity for enhancing their competitiveness. Although the US was not enthusiastic about the formation of RTAs, the creation of the EC was a way of reaping geo-strategic benefits of Western European economic unity as this would act as a counterbalance to Soviet power.

The European Common Market has evolved in distinctive phases. The establishment of the European Coal and Steel Community was the initial step towards the creation of the European Economic Community that was established in 1957 with the Treaty of Rome. The second stage (1973-85) involved the incorporation of new members as well as the reduction of tariffs. The third stage began in December 1985 when the European Commission passed the Single European Market (SEM) Act. This Act was an amendment to the Treaty of Rome and aimed at the complete elimination of barriers to the movement of goods, services and factors of production within the community. The completion of the single market by 1992 was intended to make of Europe a stronger entity within the international economy.[11] The 1992 Maastricht Treaty resolved to move towards a common European currency.

[10] Frans Buelens. "Regional Blocs in the World Economy," in Intereconomics. Vol. 27, No. 3. p. 131. May/June 1992.

[11] André Sapir. "Does 1992 Come Before or After 1990? On Regional versus Multilateral Integration." Centre for Economic Policy Research. Discussion Paper Series. No. 313. May 1989. p. 1.

The EC has begun the fourth phase of integration which may end up with a full union with no barriers among its members countries, a common currency a single monetary authority and fiscal system, and common regulatory framework and laws. Economic integration has also involved political integration and the introduction of common policies in areas such as social and environmental matters, or foreign and security policy. With respect to the EC's future perspective, it seems unlikely that the single market will become a "Fortress Europe" because the consolidation of a European Union involves a huge process of deregulation. In fact "the single market process will probably accelerate the opening of the less-open EC economies in the 1990s."[12] This process of gradual economic integration was motivated by political will of European leaders to strengthen their position vis-à-vis the US and Japan.

The EC is the only RTA that has followed gradual and well defined stages for deepening the process of economic integration. The EC's successful gradual integration sets a logical pattern to the evolution of a trade treaty from an agreement on specific sectors to a common market and an economic union. The pattern of liberalization of trade within the Community was mainly based on the liberalization of manufactures and not on a liberalization across the board. Sectors such as agriculture were clearly excluded from preferential access making this scheme incompatible with the MFN principle and inconsistent with the provisions of Article XXIV.

From 1958 to 1972 integration accompanied multilateral trade liberalization under the GATT rounds. The EC's common external tariff for manufactured products was reduced according to the tariff reductions in the Dillon and Kennedy Rounds. Thus, during its first stage the EC's trade activity resulted in an "GATT-plus" situation given that there was an expansion of extra-regional trade leading to trade creation.[13] Trade in agricultural products was the exception as this sector experienced considerable trade diversion. During the second

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[12] Gerhard Pohl and Piritta Sorsa. European Integration and Trade with the Developing World. Washington, D.C.: The World Bank, Policy and Research Series. No. 21, 1992. p. 11.

[13] André Sapir. Art. cit. p. ii.

stage (1973-85), the tariff reductions from the Tokyo Round gave rise to further trade creation in manufactures but again this was not the case in agriculture; the Common Agricultural Policy (CAP) led to an increase of trade diversion. The second phase of integration differed from the initial one in that external trade in manufactured products increased faster. Also during this period there was a relative slowdown in the levels of intra-regional trade as member countries used protectionist measures to reduce intra-Community trade. This was mainly due to the period of slow growth and high unemployment that these countries suffered at the time. The evolution of the EC was orchestrated by a supra-national authority with very rigid rules of conduct, with high costs arising from the maintenance of uncompetitive activities such as agriculture which led to huge subsidies.

At a more general level, as a result of the first stage of integration, exports among EC countries increased from 37.2% in 1958 to 53.4% in 1970. Intra-regional imports also experienced the same increasing performance going from 35.2% to 50.3% during the same years. EC exports within the region reduced by one percentage point from 53.4% to 52.4% between 1970 and 1975. During those same years EC exports to the rest of the world grew from 34.9% to 37%. With respect to intra-regional imports, its share declined from 50.3% to 49.3% during 1970-80. Imports from the rest of the world (EFTA not included) experienced a slight growth going from 41% to 42.1%.[14]

To illustrate the scope of an RTA in terms of trade creation the case of the automotive industry comes in handy. When the EC came into existence protection granted to the auto industry was high. Import tariffs in France and Great Britain were at 30 percent, in Italy between 35 and 45 percent, and in West Germany around 20 percent. During the 1960s trade in automotive products among EC countries increased probably due to the trade-creating effect of this RTA. Between 1958 and 1965 intra-EC trade in cars increased by almost 400 percent.[15]

[14] André Sapir. "Regional Integration in Europe," in The Economic Journal. Vol. 102, No. 415. November 1992. p. 1493.

[15] Rhys O. Jenkins. Dependent Industrialization in Latin America. The Automotive Industry in Argentina, Chile and Mexico. New York: Praeger Publishers, 1977. p. 25.

By 1968 tariffs for intra-regional trade in cars were reduced to zero. This liberalization allowed an increase in intra-regional trade in vehicles and led to the establishment of new plants in several European countries. Exports grew at a faster rate than production as is illustrated by the fact that French cars increased their share in the German market from 2 percent to almost 14 percent between 1958 and 1970. Imports of German cars into the French market went from 1 percent to almost 11 percent while imports of Italian vehicles into that same market also increased from 0.2 to around 6 percent during the same years. Trade liberalization allowed European firms to integrate their operations. This was the case of Renault, Peugeot, and Volvo who jointly were more capable of producing engines at full scale. Tariff reduction under the EC resulted is a GATT-plus situation because a more open trade regime allowed the creation of trade.

The East Asian Experience

A contrasting experience to that of the EC is East Asia's. RTAs in this region have been rather weak as these countries have been more supportive of an open multilateral trading system. In 1967 six countries--Brunei, Indonesia, Malaysia, the Philippines, Singapore and Thailand--formed the Association of South East Asian Nations (ASEAN) with the initial purpose of ensuring their joint security. In 1976 ASEAN developed the first and only attempt to promote regional economic integration[16] along with some development programs. These countries aimed at increasing intra-regional trade driven by an outward-oriented trade policy consistent with the MFN principle. ASEAN was constituted on the basis of tariff elimination across-the-board. Notwithstanding the lack of cohesion within ASEAN and the absence of an RTA for the whole Asia Pacific region, intra-regional trade in Asia has expanded rapidly. Countries in East Asia are trading more among themselves "simply because its markets have become so important."[17] East Asia's export within the

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[16] Arvind Panagariya. "East Asia: A New Trading Bloc?" in Finance and Development. Vol. 31, No. 1, 1994. p. 16.

[17] The World Bank. Development in Practice. East Asia's Trade and Investment. Washington, D.C.: World Bank. 1994. p. 23.

region increased from 35.6 % in 1988 to 40.5% in 1992. Intra-regional imports also experienced growth going from 42.6% in 1988 to 47% in 1992. Outside the region exports to the US declined from almost 30% to 25% during the same years. Imports also went down from 10% to 17.4%.[18] Higher costs in Japan and the NICs have led to a shift of industries to other East Asian countries increasing the trade in sectors such as electronic components and machinery. Japanese exports to the region have shown a growing trend; in 1991, Japan's trade with the rest of Asia was larger than its trade with the US.[19]

In addition to ASEAN other regional initiatives in East Asia have been the East Asian Economic Group and Asia Pacific Economic Cooperation. The formation of the East Asian Economic Group (EAEG) was proposed as a means of addressing the potential threat that other RTAs would pose for the economic activity of this region. The major players in the EAEG are Japan and China, the four NICs (Hong Kong, Korea, Singapore, and Taiwan) and four ASEAN countries (Indonesia, Malaysia, the Philippines, and Thailand). There is some skepticism about the approach in the region. Most potential members (with the exception of Malaysia) have not considered the creation of EAEG a viable proposition as they have benefitted substantially from expanding multilateral trade. Instead, several bilateral trade agreements did come into existence between China and Japan, the US and Japan, and the US and the Philippines.[20] In 1989 the Asia-Pacific Economic Cooperation (APEC) was established as a forum to discuss issues in international trade and as a possible counterweight to discriminatory practices. The East Asian economies have a close trade relationship with the whole world. Given that two thirds of their trade is carried out in the international market, it is more in the interest of these countries to maintain a strong open international trading system rather than to pursue preferential trade. Their interest towards strengthening their own regional trade was induced by the negotiation of NAFTA. The economic ministers

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[18] The World Bank. Development in Practice. East Asia's Trade and Investment. Washington, D.C.: 1994. pp. 82-83.

[19] Diana Brand. Art. cit. p. 279.

[20] The World Bank. 1994. Op. cit. p. 68.

of ASEAN have "expressed concern that NAFTA might become an exclusionary regional economic bloc."[21]

East Asian and ASEAN's trade performance has been remarkably good. This is the region that has shown the most dynamic growth in trade since the 1960s (see Appendix Table). As opposed to the European experience these countries have sought to establish stronger links with the international economy. They have relied on the MFN principle which has proven to be extremely helpful for trade expansion. Over the last 25 years East Asia's exports increased more than thirty-fold to about US$850 billion. East Asia's share of world exports increased from about 7 percent to 21 percent during this period. It is clear that GATT and MFN provided a supportive environment for East Asian trade activities. The region did not require the creation of a regional trade arrangement. Adherence to MFN proved to be superior to any kind of RTA.

Thus, economic integration in East Asia followed a very different evolution process from the EC. Attempts to create RTAs have been rather weak, if deliberately so, and the scope of the agreements narrow. The thrust of regional economic integration has been overshadowed by a multilateral approach to the world market. East Asian economies depend on resources within and outside the region. These countries felt that they were "too small or too narrowly endowed to be self-sufficient."[22] Most of them have encouraged linkages with the world market and have developed the infrastructure and business experience to coordinate international investment, production and trade. Trade has been the instrument for economic growth in East Asia.[23]

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[21] Richard Steinberg. "Antidotes to Regionalism: Responses to Trade Diversion Effects of the North American Free Trade Agreement," in Stanford Journal of International Law. Vol. 29. Summer 1993. p. 317.
[22] The World Bank. Op. cit. 1994. p. 21.
[23] Ibid. p. 28.

Latin American Experience

When comparing the Latin American experience with these two regions the issue that arises is whether it is better to adjust to GATT rules and disciplines as in the East Asian case, or if it is worth getting involved in an RTA of the European Community type. There are several elements that need to be taken into consideration to assess the costs that the Latin American region would have to pay for departing from the MFN principle.

Since the 1940s regional economic integration in Latin America was considered an instrument for promoting economic growth and industrialization. In the 1960s the European experience stimulated Latin American countries to follow a path of regional economic integration, although based on a completely different economic approach.[24] The Latin American Free Trade Association (LAFTA) created in 1960 incorporated the import substitution orientation for Latin American industrialization policies. In order to deepen the import substituting industrialization process, those countries which had small markets tried to reach economies of scale through the preferential opening of their markets. It was felt that regional trade agreements would lead to rapid industrialization.

In 1969 the Andean Pact was established as a sub-regional agreement within LAFTA. The Andean Pact showed the worst performance in terms of intra-regional trade given the complex regulations set to implement the agreement and the emphasis on promoting import substitution. The attempts of the 1960s could not be successful given that these agreements did not "use trade liberalization and hence prices to guide industry allocation."[25] Instead this was done through a bureaucratic negotiation in which regional integration programs tried to replicate each country's distorted inward domestic-oriented policies.

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[24] Jagdish Bhagwati. Op. cit. 1991. p. 70.
[25] Idem.

LAFTA and the Andean Pact were not capable of increasing trade in the region nor at the world level. These RTAs were negotiated on a product-by-product approach instead of covering all sectors of the economy. Complete sectors were excluded or privileged according to the domestic and political interest within each country. Hemispheric trade was far from dynamic. The share of intra-regional trade in the total region's trade fell between 1978 and 1989, quite contrary to the objectives of expanding intra-regional trade.[26]

The Central American Common Market (CACM) formed by Costa Rica, El Salvador, Guatemala, Honduras, and Nicaragua also followed an inward-oriented trade strategy but was more "successful" in expanding intra-regional trade. Unlike other Latin American initiatives at the time, the CACM provided a liberalization across-the-board based on the MFN principle.[27] The purpose was to reach a common market which would provide a preferential market for import substituting industries. This liberal approach adopted among the member countries was evident in the non-discriminatory rules and in the national treatment granted to investment. During the 1970s the CACM suffered a crisis due to the "internal frictions mounted over equitable sharing of benefits"[28] and, in 1986, the collapse of the Central American payments clearing mechanism marked the disintegration of the CACM.

The 1980s were a decade of major economic transformation for the Latin American economies and a period for renovating regional integration schemes. The need to respond to the region's financial and economic crisis led to the liberalization of most Latin American trade policies and to the adoption of outward-oriented trade strategies coupled with economic stabilization and the privatization of many public enterprises. Latin American countries carried out a substantial unilateral trade liberalization process without precedent.[29]

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[26] Susan Hickok, et al. The Uruguay Round of GATT Trade Negotiations. New York: Federal Reserve Bank of New York. Research Paper. June 1991. pp. 21.-22.

[27] Julio J. Nogués and Rosalinda Quintanilla. "Latin America's Integration and the Multilateral Trading System." Paper presented at the conference on New Dimensions in Regional Economic Integration. The World Bank and Centre for Economic Policy Research. April 2-3, 1992. pp. 10-11.

[28] Ibid. p. 32.

[29] Asad Alam and Sarath Rajapatirana. Trade Policy Reform in Latin America and the Caribbean in the 1980s. Working Paper 1104. Washington, D.C.: World Bank. 1993.

The Latin American countries made revisions to the trade agreements of the 1960s with the idea of revitalizing the process of regional economic integration which started a new wave of regionalism. These schemes of regional economic integration differ substantially from those of the 1960s as they acknowledge the need of Latin American economies to compete in the world market and to increase market access for their exports. This trend was taking place within a context of export promotion and growth of international trade throughout most of the developing world.[30] Bhagwati observed that, "this is a second regionalization based on open trade compared to the first regionalization based on protection."[31]

Recent RTAs are different from those of the 1960s in another aspect. They go beyond the liberalization of trade in goods; they also cover other areas such as investment, services or transportation (this has been called "deep integration"). Some of them are revisions of existing regional agreements while others are completely new. Among those RTAs that resurrected are the Andean Pact and the Central American Common Market. Among the new agreements are Mercosur, the Group of Three, and several bilateral trade arrangements.

The Andean Pact was revived after years of near total stagnation. Renovating this pact involved not only trade in goods but also the liberalization in other areas. The new agreement established the creation of a free trade zone starting in 1992; an agreement on the level and structure of the common external tariff (CET) starting December 1991 and the implementation of the CET by December 1995. It went beyond trade to cover the liberalization of maritime and air transportation as well as that of foreign investment and capital mobility within the Andean group.[32] In spite of this integration effort, the level of intra-regional trade remained quite low. The process of determining the CET has been

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[30] Sebastian Edwards. Art. cit. p. 34.

[31] Jagdish Bhagwati. "Regionalism versus Multilateralism," in The World Economy. Vol. 15, No. 5. September 1992. p. 542.

[32] Sebastian Edwards. Art. cit. p. 37.

extremely contentious because there is a lack of commitment to compromise and to grant concessions. Given the reluctance to pay the price of adjustment that regional integration demands, it is hard to contemplate the successful completion of the Andean integration process. This RTA has faced more serious obstacles than other recent arrangements in the region.

In Central America the pacification of the region as well as the economic reforms have led to a renewal of regional integration efforts. The CACM aims to establish a common market. The range for the common external tariff has been set at a level between 5 and 20 percent. This is also consistent with its initial liberal approach. The CACM has incorporated two new members; Panama which was not a member earlier, and Honduras, which had withdrawn in 1969. The CACM has an open and liberal orientation. It seeks to increase trade among its members and with the rest of the world. The trade liberalization process has also been accompanied by fiscal and monetary policies which are aimed at a stable macroeconomic environment.

In March 1991 Argentina, Brazil, Paraguay, and Uruguay signed the Asunción Treaty which established Mercosur. Under the agreement Brazil and Argentina are scheduled to phase out all tariffs and non-tariff barriers to intra-regional trade by the end of 1994 while Uruguay and Paraguay will have an additional year. By 1995 it is expected that almost all trade barriers among the four member countries will be removed; identical trade policies are to be established with a framework to adopt a common external tariff to govern international trade between Mercosur and the rest of the world in the future. Mercosur also covers agricultural, industrial, monetary, financial, and transportation policies and sets common rules to deal with subsidies, dumping ,and other unfair trade practices. Mercosur's future largely depends on the policies of both Argentina and Brazil.[33] The continuing

[33] Brazil accounts for 82.2% of total production of goods and services, or US$ 375 billion out of a total Mercosur market worth US$ 456 billion (Argentina makes up 15.1% of the total, Uruguay 1.5% and Paraguay 1.2%). "Unifying the Hemisphere," in The Financial Post. December 26, 1992, Saturday, Weekly Edition.

macroeconomic instability in Brazil casts a shadow over the agreement on a common external tariff even though a framework for it has now been agreed upon.

There has also been a proliferation of bilateral or trilateral regional initiatives. Colombia and Venezuela have negotiated a free trade agreement with Mexico known as the G3 Agreement (*Grupo de los Tres*) which will become effective on January 1, 1995. Mexico has signed a free trade agreement with Costa Rica and another one with Bolivia, and is in the process of negotiating agreements with El Salvador, Guatemala, and Honduras. Colombia has established a customs union with Venezuela and a free trade area with Ecuador. So far Colombia has been the "most energetic proponent of free trade."[34] When Gaviria became president in 1991 Colombia had no single trade agreement. By August 1994, Colombia would have signed free trade arrangements with 22 countries. Mexico has also been very active in regional integration and has tried to develop stronger trade links with the rest of Latin America through the creation of regional trade treaties. It is expected that by the end of the 1990s most tariffs within Latin America will be completely eliminated.[35]

Western Hemisphere Initiatives

US support for regionalism became evident with its negotiation of several bilateral and regional trade agreements throughout the 1980s. In 1983, consistent with the orientation towards regionalism and following the provisions in GATT's Article XXIV, the US negotiated the Caribbean Basin Act which covered liberalization of trade and investment. In 1985 the US negotiated a free trade agreement with Israel.

Regional trade in North America was shaped after the 1965 Auto pact between Canada and the US. The Canada-US Automotive Products Agreement of 1965 or Autopact constituted a sectoral regional trade agreement that served to integrate production between

[34] "In Latin America, a Free Trade Rush," in The New York Times. June 13, 1994. p. D5.
[35] Ibid.

both countries. The Autopact allowed a tariff reduction (17.5% to 0) on Canadian imports from the US of autoparts and components to be used as original equipment. US imports from Canada of similar products which had a 6.5% tariff became duty free under the Autopact. As a result of this reduction in tariffs, US vehicle manufacturers shifted part of their production facilities to Canada and began producing certain models for both markets. US plants were able to produce autoparts and components taking advantage of economies of scale.

The Autopact allowed free trade in autoparts for vehicle producers in Canada and the US. Its result was a rapid increase in trade in both vehicles and components. Tariff reduction allowed a rationalization of production as well as a specialization of plants in each country. This RTA has been considered a GATT-plus agreement because it led to higher levels of trade than those that would have been possible under MFN at reduced protection. The Autopact allowed the creation of trade as illustrated by the fact that during the first 10 years exports of US vehicles to the Canadian market increased by 10% while Canadian exports to the US increased by more than 20%. Given that Canada was the market that maintained the higher tariff levels it experienced a more rapid trade growth when import tariffs for automotive products came down to zero. Trade in autoparts and components also had a significant increase, although it was not as strong given the Canadian performance requirements of local content and trade balance, incorporated in the Autopact.[36] In this context a question arises as to whether Canada and the US could have reached higher levels of trade creation if they had stuck to a MFN approach. This is of course difficult to determine because one can not know whether the prevailing MFN trade in cars was the best possible, so that the increase in trade following Autopact is additional or GATT-plus. However, this sectoral agreement was taken as an example of the benefits provided by regional trade arrangements in terms of specialization of production and enhanced competitiveness. The negotiation of the Canada-US Free Trade Agreement (CUSFTA) took place in 1988. At that time, the Canada-US Free Trade Agreement was considered the most

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[36] Rhys Jenkins. Transnational Corporations and the Latin American Automobile Industry. London: McMillan, 1987. pp. 31-32.

ambitious project of regional economic integration after the EC.[37] The CUSFTA was presented as an instrument through which the US industry would be able to regain a competitive edge in the international market because it would facilitate the specialization of production and would eliminate barriers to trade in goods and services. Thus, the aim was not only to facilitate trade, but more importantly, to develop a mechanism for building a stronger bloc to compete vis-à-vis the rest of the world.

The US also entered into trade arrangements with Mexico during the 1980s. In 1985 both countries signed the Bilateral Agreement on Subsidies and Countervailing Duties, and in 1987 the Framework Agreement on Investment and Trade. Given the outward-orientation of the Mexican economy following the mid 1980's trade reforms and the rising administrative protectionism in the US market these agreements were crucial for Mexico to have guaranteed access of its exports to its main foreign market. In 1991 Canada, Mexico and the US began negotiations for a trilateral free trade agreement which also extended to areas such as investment, financial services, telecommunications, and transportation. With the incorporation of Mexico the North American market would become the largest single market in the world with 360 million people and a GDP of around US$6 billion. NAFTA can best be described as a "freer rather than [a] free trade agreement"[38] because even after the transition period is over some trade barriers will be in effect.

NAFTA is a case of a free trade association between two industrialized and one developing country. It has been argued that the gains for a developing country from integration with a rich country go beyond the trade efficiency gains and this does apply to Mexico. In the event that the international trading system would evolve into a series of inward-looking arrangements such integration guarantees future access to a large market. With this large market, it is most likely that the developing country like Mexico could

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[37] Juan A. de Castro and Serafino Marchese. El Acuerdo de Libre comercio entre Estados Unidos y Canadá y su Impacto sobre el Comercio de América Latina y el Caribe. Geneva: UNCTAD. September 1990. Paper #33. p. 1.

[38] Kym Anderson and Richard H. Snape. "European and American Regionalism: Effects on and Options for Asia." Centre for Economic Policy Research. Discussion Paper Series. No. 983. p. 13.

maintain a certain level of efficiency and have access to new technology.[39] Thus, for Mexico the negotiation of a free trade agreement with the US appeared as the best mechanism for securing access to the American market which represents around 70 percent of its exports, to increase foreign investment inflows, and to reduce the uncertainties derived from administrative protectionism in the US.[40] In addition, a free trade agreement with the US added discipline and certainty over domestic policy reforms in Mexico. On the US part, even though labor and environmental organizations lobbied against signing a free trade agreement with Mexico, the NAFTA negotiations were justified on the basis of improving the competitive position of US industry and the creation of jobs.

Unlike the regional trade initiatives of the 1960s it seems that the new wave of "regionalism is likely to endure this time."[41] It is difficult to assess the gains and losses from intra-regional trade to the whole international trading system. The proliferation of regional trade arrangements does not necessarily mean a more open international trading system or that these agreements are "cooperative across groups."[42] RTAs have increased the use of non-tariff barriers and protectionist measures. For example, in the 1990s the share of imports subject to non-tariff barriers in the EC has increased. Anti-dumping measures and voluntary export restraints (VERs) have also been widely used for granting protection to domestic producers. Restrictive rules of origin have also acted as barriers to trade. Regional initiatives among Latin American countries differ from those of the 1960s because they are outward-oriented while almost all participants have undergone a process of unilateral trade liberalization as part of major domestic economic reforms.

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[39] Jaime de Melo. Arvind Panagariya and Dani Rodrik. The New Regionalism. The World Bank: Washington, D.C. February 1993. Working Paper Series 1094. p. 20.

[40] Julio J. Nogués and Rosalinda Quintanilla. Art. cit. p. 36.

[41] Jagdish Bhagwati. Art. cit. p. 540.

[42] Sebastian Edwards. Art. cit. p. 42.

IV. Trade Creation and Welfare Effects

The advantages and disadvantages of RTAs have to be evaluated from the welfare effects of these departures from MFN. Early analysis by Viner was based on the concept of trade creation and trade diversion, which was essentially a static analysis of welfare gains[43]. If net trade creation is positive then an RTA is considered to be beneficial to the parties creating it. A more dynamic view of these initiatives must take into account the learning, coordination, and bargaining position of the RTAs compared to their absence. Such an analysis must incorporate political economy elements of forming RTAs. Bhagwati observes that this analysis must consider the interests of three main agents: governments of member countries, interest groups within member countries and interest groups and governments outside member countries[44].

In theory, it has been shown that welfare-improving FTAs could well be designed. Kemp and Wan demonstrated that when creating an RTA (in this case a customs union), the member countries could adopt a common external tariff structure that is endogenously determined, which could improve their welfare without hurting the rest of the world. The main idea is that "the common set of tariffs may be chosen in such a way that the external terms of trade and hence the quantities trade[d] with the outside world are unchanged while internal trade is rearranged to maximize the gains from it."[45] When trade creation occurs as a result of specialization, a regional trade agreement can become a mechanism for improving the welfare of the trading partner's economies.[46]

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[43] Jacob Viner. The Customs Union Issue, Carnegie Endowment for International Peace. 1950.
[44] Jagdish Bhagwati. "Regionalism versus Multilateralism." The World Economy. 1992. Vol. 15, No. 5.
[45] Jaime de Melo, Arvind Panagariya and Dani Rodrik. The New Regionalism. Working Paper Series 1094. Washington, D.C.: The World Bank. February 1993. p. 6.
[46] Kym Anderson and Hege Norheim. "History, geography and regional economic integration," in Kym Anderson and Richard Blackhurst. eds. Regional Integration and the Global Trading System. New York: Harvester Wheatsheaf, 1993. p. 20.

However, RTAs do not necessarily increase global welfare or even the welfare of the member countries due to trade diversion. Trade is diverted when imports that used to come from third countries at lower prices become relatively more expensive due to the preferential access granted to a higher cost source within the agreement. By diverting trade from outside to the inside the region, global as well as regional, welfare is reduced. So world production is diverted from least-cost to higher-cost supply sources and therefore the world allocation of resources worsens. But more importantly, the region loses. Consumers within the region have to pay higher prices and the shift in production within the region leads to a high cost or more inefficient production. When the dynamics of this is considered, if one can show that the increase in costs is a short-run phenomenon and that over time the costs could be reduced by learning, then there is some semblance of dynamic gain. But then the question arises whether forming an RTA is the best way of inducing learning and cost reduction.

It has been observed that it is "nearly impossible to determine definitively and precisely whether trade creation or trade diversion predominates as a result of the establishment of any particular regional trade agreement."[47] The case for or against regional trade arrangements is hard to define. Formation of an RTA may improve the union's terms of trade vis-à-vis the rest of the world. Experience provides conflicting evidence to support or reject RTAs on the basis of trade creation and trade diversion. The CACM and the EC are examples of arrangements that were successful in creating trade. However, under MFN, their trade gains could have been even greater. At the other extreme, the LAFTA showed a substantial level of trade diversion and very little trade creation. However, the actual results show that "most preferential trading blocs accomplished little, neither creating nor diverting much trade."[48]

A recent study that analyzed the trade effects of the SEM on developing countries concluded that exports of agriculture and primary products from these countries into the EC

[47] Richard Steinberg. Art. cit. p. 322.
[48] The World Bank. Op. cit. 1994. p. 65.

will suffer from trade diversion as a result of the consolidation of the European market. Exports of manufactures from developing countries might benefit from the trade creation effects which will most likely encourage trade exchange in high-tech industries and machinery.[49] Those that will be able to take advantage of this trade creation will mostly be the East Asian countries as they are the major suppliers of these kinds of products among the developing countries. In the case of the ACP (African, Caribbean, and Pacific countries) and Latin America some countries will be seriously damaged by the diversion in trade of primary and agricultural products.

East Asia is a case in which regional trade agreements have been very loose in terms of their coverage and their institutional capacities. These economies have basically looked to the world economy. Intra-regional trade as well as investment flows have not been hampered as a result of weak RTAs. On the contrary, trade among these countries may have increased even more than under a strong RTA. Since these economies will remain outward-oriented, intraregional trade will continue to grow as further liberalization takes place and the barriers to foreign direct investment are eliminated. In this respect ASEAN and other East Asian RTAs could be thought of as GATT-plus given the increase in regional and international trade levels. The East Asian experience makes the case for supporting an open multilateral trading system. It provides strong evidence for arguing that RTAs are not necessarily the alternative for promoting intra-regional trade creation. In spite of a non-cohesive regional scheme East Asian countries have been able to increase their trade and investment flows. The attempt to strengthen ASEAN has been more in response to the perceived threat of regional trading blocs and the undermining of the multilateral trading system rather than to the interest of consolidating a regional trading bloc. Given the successful completion of the Uruguay Round these countries are well positioned to carry out further trade liberalization.

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[49] Parvin Alizadeh. "Trade Effects of 1992 and the Developing Countries," in Journal of International Development. Vol. 5. No. 2. 1993. pp. 161, 167.

But trade creation alone cannot be a judge of a trade treaty. Non-trade issues come into play. Indeed the dominant motive for the EC was a political one - to have an entity that could counterbalance the Soviet power that emerged after the Second World War. Similar considerations are important today. Many of the new initiatives for RTAs are based on the notion of bargaining power, they assume that non-membership could weaken the bargaining position of one country and/or a group of countries.

Apart from political considerations there are domestic and foreign political economy elements that come into play in considering the advantages and disadvantages of RTAs. An RTA that commits member countries to bind the tariff pattern could be used to achieve GATT-plus trade creation. This is the case if a country does its best to liberalize its trade regime under MFN, but finds a limit to the ability to reduce protection beyond a certain level, then an RTA could be used to "buy out" domestic interests who oppose further liberalization. The other example is when an RTA becomes a more credible insurance against reversal than under MFN, as is the case of Mexico in NAFTA. An undertaking given to the US not to retract the mutual exchange of concessions is more credible than one to a multilateral body. Thus, a commitment under MFN could be less powerful since there is limited policing of the newly emerged regime and no strong sanction against breaking the commitment. This is true since dispute settlement under GATT has been remarkably weak. There is some hope that the strengthening of the dispute settlement mechanism under WTO will go some way to readdress this weakness in the international trading system.

V. Minimizing Trade Diversion and Other Risks

Since there are definite prospects for trade diversion in forming RTAs and the benefits and costs, or advantages and disadvantages, cannot be clearly and easily determined a priori, there is merit in a strategy that minimizes risks from forming RTAs. Such a strategy would constitute of a number of elements. It should have both an international and domestic perspectives.

From an international perspective there is no doubt that Article XXIV has to be strengthened so that the departures from MFN are subject to a close scrutiny. An attempt was made at the Uruguay Round to do this, but met with limited success. Two provisions have been better defined within the article. The transition period for the formation plan of an RTA has been defined, so that there is a clear transition period that should not exceed 10 years. Also, a formula for the definition of the average tariff has been adopted. In addition, the improved dispute settlement under the WTO could be a deterrent against highly discriminatory trade agreements. One loophole that remains is the "enabling clause" that is granted to developing countries in which Article XXIV provisions need not be met in forming RTAs. But international public opinion and those industrial countries which have become increasingly intolerant of special and differential treatment would help to prevent the use of this route widely.

The real guard against the disadvantages of RTAs has to remain with the countries themselves.

The first line of defense against the deterioration of an RTA into a trade diversion device is to have low protection in the first instance. This means that the potential for trade diversion would be reduced because the profitability of substituting for imports from low cost third parties is low. In other words, it guarantees that the departure from MFN is limited. This departure is a second-best option when compared to MFN but it is better than no trade at all. Bringing in political economy arguments into the discussion, it is possible to assess that when there are sectors within each country that will do whatever they can to maintain protection at the expense of other groups or the whole economy, then an RTA can be useful. An RTA can become a mechanism for buying out the resistance of this group because this kind of arrangement will offer greater market access for these sector's production. Thus, an RTA that enables a reduction of tariffs and promotes lower costs and increased competition will result in trade creation, though it may not be the first-best option.

The second is to have open RTAs. That is, keep the membership open to all others who are willing to subscribe to the provisions of the RTA. This means to make accession an easy process (this is in contrast to the EC, which kept Britain out of the agreement for decades). The theory supporting the easy accession is that the larger the area under an agreement, the more diverse would be the resource base and the more likely it would be to have lower production cost for a variety of products. Thus NAFTA is an open agreement--others can join. Both Chile and Argentina are said to be in the process of becoming "preferred associates." Moreover, the US for the most part is oriented towards free trade which implies that the cost structure in the US is also nearly akin to world free trade.

Third, while member countries should have lowest possible tariffs, and tariffs being the only form of protection, an attempt must be made to increase competition within the RTA by removing existing laws that might limit competition. This would lead to the adoption of competition policies that go beyond what is possible from free trade within a group. Thus harmonization of rules and regulations will permit keener competition across frontiers and in non-tradable sectors.

Fourth, there must be an accompanying process of multilateral trade liberalization so that between the member countries and versus the rest of the world come closer over time. For this to happen, an institutional mechanism must be in place that continues the push towards greater liberalization with the rest of the world. The bargaining power created by an RTA could be used to get greater access to other markets. So in the dynamic sense, the RTA becomes an instrument for further liberalization. It is sometimes hoped that the bargaining and negotiations could be facilitated when carried out among groups of countries as opposed to those among individual countries. In this sense, RTAs are seen as building blocs, rather than stumbling blocks.

Fifth, macroeconomic policy coordination becomes important if competitive forces are to be mobilized to have a better allocation of resources within an RTA. Thus, there is a challenge for Mercosur to adopt a common external tariff with the increasing inflation in

Brazil and the parallel appreciation of the Argentine currency. The framework for adopting a common external tariff requires macroeconomic policy coordination.

Sixth, a common market is preferable to a free trade area to the extent that a common market vitiates the need to have rules of origin. The enforcement of rules of origin could lead to the creation of a bureaucracy. That would in turn introduce discretionality and bring in an old style quantitative restriction-like administration of the trade regime.

Finally, policy and institutional support for reducing barriers may not be enough and there could be attempts to increase competition through improving access to countries via better roads, ports and communication means.

VI. Conclusions: Lessons for Latin America

MFN-based trade has long been accepted by main stream economists as first best. When political economy considerations are brought into play, and real world constraints to the first best are taken into account, departures from MFN principle seem inevitable. But all is not lost. The very political economy aspects could be marshalled to attain the liberalization of trade by RTAs, beyond what would be feasible under unilateral MFN-based trade. This has been called GATT-plus or MFN-plus trade. The conditions needed to achieve such a state may be good in the majority of the Latin American countries given the liberalization of their trade regimes in the mid 1980s to the early 1990s.

The conditions for getting these gains and minimizing the risks of trade diversion can be easily recognized. This implies following the international rules for creating RTAs through the revised Article XXIV and eschewing the use of the enabling clause route. At the national level attempts must be made to have the lowest possible protection level permitted by domestic political economy considerations and to negotiate for further reductions in protection when an RTA is formed. Paradoxically, departures from MFN then could be used to increase the extent of trade subject to MFN. Thus, Mexico's accession to NAFTA with a trading partner such as the US that follows international rules can give guaranteed access to its market,beyond what is available under "free trade" and can also help to insure against reversals by the pre-commitment to open trade by Mexico.

There does not seem to be an inexorable pattern for RTAs to graduate from free trade to customs unions and economic unions even though the European Union has followed such a path. There is no economic logic of RTAs that propels them along such a path. In the case of the European Union it may be the dominance of the political commitment to unity and the creation of a supra-national entity that enabled to evolve into an economic union. The departures from MFN have imposed costs in the form of the huge subsidies the Community has had to pay to agriculture as it became increasingly uncompetitive compared to the rest of the world. Equally, RTAs do not automatically guarantee that the trade among the group could increase, or for that matter such an increase is beneficial, if it leads to trade diversion. The East Asian experience of MFN trade liberalization serves as a good reminder of the advantages of MFN liberalization not only for its trade creation, but also for the rapid increase of intra-regional trade due to MFN-based trade liberalization. The past Latin American attempts at integration were condemned to failure because they were motivated by protection and large departures from the MFN principle. Clearly, intra-regional trade contracted as a result of the attempt to increase this trade on a preferential basis.

To gain the benefits from the RTAs already in existence Latin American countries could do well to participate strongly in the WTO disciplines and continue their efforts at trade liberalization. They could attempt to forge links among existing agreement to enlarge the area for trade, open up hitherto restricted sectors and eschew the use of the escape clause if new agreements are to be signed.

A final consideration for these countries is to increase competition through better harmonization of tax, regulatory and corporate policies and the creation of infrastructure that reduces the costs of transport and leads to the reduction of natural barriers for competition.

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