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Why "Rebuilding the Caribbean" Requires NAFTA Parity for CBI Countries: Towards a " Win-Win" Strategy

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Summary

Hurricane Mitch has been the second big blow to the Caribbean region in the last five years after the North American Free Trade Agreement (NAFTA) tilted the balance of incentives away from the Caribbean Basin Initiative (CBI) countries and toward Mexico as a site for production, investment and trade. By the year 2005, the Multi-Fiber Agreement (MFA) will be completely phased-out, and Asian producers will compete on even terms with those in the Western Hemisphere. Much of the textile and apparel industries in the U.S. and Latin America are at risk from this development, unless new incentives encourage new investments forging strategic partnerships in the region with productivity gains that reinforce the inherent advantage of being close to the U.S. market.

This paper focuses on the reasons for extending NAFTA parity to the CBI countries which can be grouped into humanitarian, economic, and security arguments. The relative poverty of the CBI countries, with a few exceptions, is well documented. While the humanitarian reasons and security issues are important, the authors believe that sustaining arguments are clear, compelling and well understood and therefore focus more narrowly on the issue of how extending NAFTA parity to CBI countries will help the economies of both those countries and the United States.

* *With the assistance of Andrew Dyer, Graduate student in Commercial Diplomacy and International Policy Studies, MIIS and Angel Orozco, Staff Research Associate, UCLA NAID Center.*

I. INTRODUCTION [1]

Hurricane Mitch blew through the Caribbean in late October of 1998. In addition to the human tragedy of over 10,000 deaths, damage to infrastructure (primarily roads and bridges) in the two hardest hit countries, Nicaragua and Honduras, alone was estimated at more than $ 5 billion. Seventy percent of the growing crops were destroyed, causing massive unemployment (the fraction of the population in agriculture is three-fourths in Honduras and two-fifths in Nicaragua). How will the battered economies of the Caribbean

survive, much less continue to make payments on their international debts (over $ 10 billion in Honduras and Nicaragua alone)? Beyond the limited resources of the Inter-American Development Bank and other multilateral organizations, what investors will gamble on locating factories and new infrastructure projects in the region now?

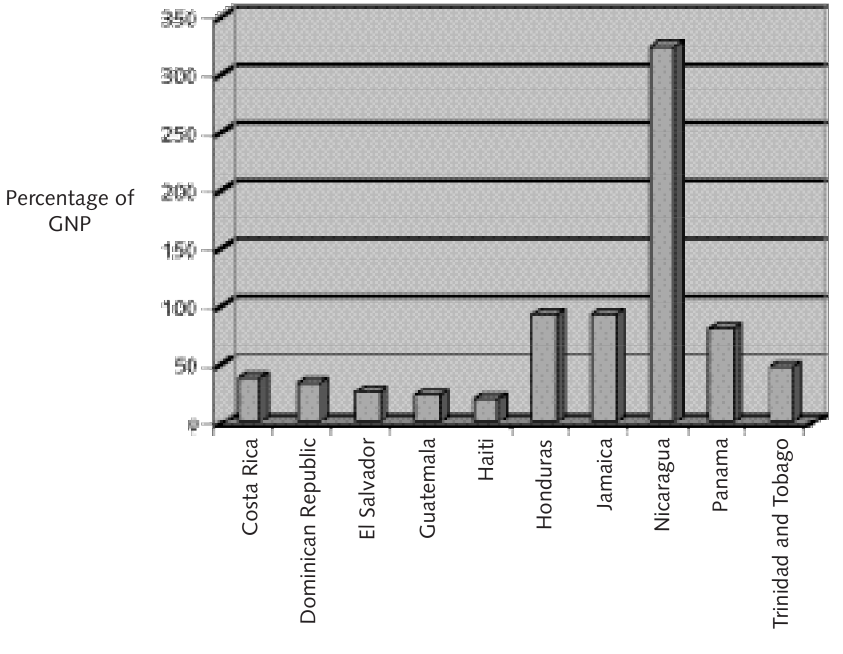
Mitch was actually the second big blow to the region in the last five years. The North American Free Trade Agreement (NAFTA) tilted the balance of incentives away from the CBI countries and toward Mexico as a site for production, investment and trade. The key difference, as we will explain in detail below, is that the CBI encourages assembly plants, while NAFTA has led to legitimate industrial integration and production sharing, creating more benefits for both the U.S. and Mexico.

Looming on the horizon is the third big blow, perhaps the knock-out blow for the region. By the year 2005, the MFA will be completely phased-out, and Asian producers will compete on even terms with those in the Western Hemisphere. Much of the textile and apparel industries in the U.S. and Latin America are at risk from this development, unless new incentives encourage new investments that forge strategic partnerships in the region, generating productivity gains that reinforce the inherent advantage of being close to the U.S. market.

Reasons for extending NAFTA parity to the CBI countries can be grouped into humanitarian, economic, and security arguments. The relative poverty of the CBI countries, with a few exceptions, is well documented. The Inter-American Development bank estimates that over 60 percent of the populations of Honduras and Guatemala live in poverty. Haiti and Nicaragua would undoubtedly match or exceed this poverty rate, if such detailed data were available. The picture becomes even more dramatic when the debt obligations of these countries are considered (see Figure 1, below).

Figure 1

External Debt as Percentage of GNP



The economic demands of servicing such large debts can take a dramatic toll on the ability of a nation to provide services to its people. Coupling the enormous debt service obligations with the potential trade diverting effects of NAFTA lends the case for NAFTA parity a sense of urgency for those who will be affected the most. Note that NAFTA parity and debt relief can potentially be mutually reinforcing for economic development in the CBI countries. Yet of all CBI countries, the current World Bank-IMF-US proposal includes debt relief only for tiny Guyana.[2]

Security issues are also rather straightforward, and detailed analyses are available from other sources. Originally, the CBI was introduced as an aid program, which would boost the economies of that strategic region. It was designed to give nations such as Haiti, the poorest in our hemisphere, a leg up. A boost in international trade was intended to translate into greater economic security for the Caribbean, and by extension, the U.S. as well. The security dimension can be extended to issues of undocumented immigration and drug production and distribution, as well. The standard argument is that increased economic opportunities for citizens of CBI countries provide alternatives to immigration and illegal activities, which have security benefits for the U.S.

While the humanitarian reasons and security issues are important, we believe that the arguments in these areas are clear, compelling, and well understood. Thus we will focus more narrowly on the issue of how extending NAFTA parity to CBI countries will help the economies of both those countries and the United States.

The rest of the paper is organized as follows. In section II, the impact of NAFTA on the CBI countries is documented, looking in detail at the textile and apparel industries, and it is compared with the impact projected by the North American Integration and Development Center (NAID Center) research with estimates of the actual impact to date. Section III contains an analysis of labor supplies in NAFTA, NAFTA+CBI, and Asia, comparing each with the labor requirements for integrated textile and garment production. It is shown that NAFTA+CBI can produce at a lower cost than NAFTA alone, improving the competitiveness of North American garment and textile production relative to Asian production. In section IV, there is a look at how extending NAFTA parity to the CBI region would benefit the U.S., both in terms of short-run efficiency gains and long-run productivity enhancement. Section V focuses on economy-wide benefits to the CBI countries, and refutes claims that NAFTA parity would somehow hurt the CBI countries.

There is a focus on garments and textiles in much of the following analysis for three main reasons. First, garments and textiles account for many of the largest and fastest growing elements of production, exports, *and imports* in CBI countries. Second, this recent growth is related to special market access granted as part of the original CBI initiative. The "leg-up" once enjoyed by CBI countries in apparel was based on a so-called 807 exemption in which garments made of U.S. fabric and cut in the U.S. can be assembled in CBI countries and exported to the U.S. duty-free. Third, NAFTA confers special status on Mexico particularly in the areas of garments and textile trade. The 807 exemption pales in comparison to the NAFTA privileges enjoyed by Mexico, whose goods can enter the U.S. duty-free as long as they originate entirely from the NAFTA region. Thus, much of the trade and investment diversion resulting from NAFTA has been and will continue to be in these key sectors.

II. How NAFTA Hamstrings Industrial Development in the CBI Countries

Around the time of the passage of NAFTA, a number of researchers predicted that the results of a U.S.-Mexico preferential trade liberalization could have a negative effect on Central America. Most of these a-priori predictions were based on the possibilities

of trade diversion and investment diversion, which are common after the setting up of preferential trading agreements. A number of Computable General Equilibrium (CGE) models have been constructed to actually measure the potential nature of these trade diversion effects.[3] These models are based on the data detailing the relative cost competitiveness of each country in North and Central America, as well as the pattern of trade and trade barriers. The models are used to estimate the impacts of alternative scenarios of trade liberalization in the region, concentrating on trade flows, output, wages and profits. How tariff elimination will impact the economies and key sectors throughout the region will thus depend on the nature of pre- and post-NAFTA tariff barriers.

Trade Barriers

Despite the high volume of trade in throughout the North and Central American region, there are a number of import barriers such as tariffs, quotas and non-tariff barriers. Despite NAFTA, Mexico has an average tariff rate on U.S. imports more than three times higher (4.2 percent) than that of U.S. protection on imports from Mexico (1.4 percent). Both Mexico and the United States still place high tariffs on certain agricultural products. Average barriers in Central America and the Caribbean are significantly higher, at 19.3 percent and 21.7 percent, respectively. Both regions have high import barriers on light manufacturing, with a 46 percent tariff making this Central America's most protected sector. The Caribbean region also makes it difficult to access the agricultural program crops and consumer durables markets with trade weighted average tariffs of 36 percent and 34 percent, respectively.

In the capital goods, intermediate goods, and other light manufacturing sectors, Caribbean reliance on the U.S. is considerable despite relatively high tariffs (20.5, 13.3, and 27.7 percent). In the case of Central America, asymmetry is lower but import barriers are higher in the light manufacturing and intermediates sectors. Given this fact, there is clearly room for U.S. expansion into these markets. Free trade would lower the costs of these items and help stimulate production in other export sectors in Central America and the Caribbean, which could in turn further increase demand for U.S. intermediate and capital goods.

About half of the U.S. exports of food corn are destined for the Mexico, Central America and the Caribbean, with all three areas purchasing all or most of their imports of this product from the U.S. This was despite the fact that Mexico's pre-NAFTA trade barriers on corn were among the highest of any sectors in North America. Pre-NAFTA research on these trade flows and Mexican high tariffs, along with the huge productivity differences, indicated a large disruptive potential due to the liberalization of Mexican agriculture, and particularly the food corn sector. Although NAFTA will not dismantle all non-tariff barriers, and in fact Mexican subsidies to the maize sector will be increased, the large number of workers who could be affected signals the migratory pressures that would be generated by severe disruptions in the sector (Robinson, Burfisher, Hinojosa, and Thierfelder, [1992] pp. 455-514) This set of Mexican circumstances, however, is not the case for Central America. Central American protection rates on corn are one-tenth that of Mexico pre-NAFTA rates and the economies in the region are much less dependent on the food corn sector.

Model Results

The results of the NAFTA-Central America CGE modeling exercises (Hinojosa-Ojeda, et al [1996] and [1999]; Hinojosa-Ojeda and Yunez-Naude [1999]) have consistently shown a negative impact on Central America from NAFTA due to an increased concentration of trade between the NAFTA partners and a diversion of imports and exports by the NAFTA partners away from Central America and the Caribbean. Intra-North American exports for the U.S. and Mexico were predicted to grow by over 20 percent strictly due to the «static»

effect of NAFTA tariff elimination, while it was estimated that trade with Central America would decline by 4-8 percent, depending on the country.[4] In the dynamic results, U.S. intra-regional exports increase while Mexican intra-regional imports rise, signifying a relative enhanced competitive position of the U.S. due to NAFTA. Intra-regional imports by Central America fall further in the dynamic NAFTA scenario, as do extra-regional exports. In both the comparative static and dynamic results, it is also seen a decline in total exports and imports by Central America. This decline is due both to the NAFTA trade diversion effect as well as to a decline in extra-regional exports by Central America, signaling the difficulty in shifting their exports from North America to the rest of the world.

The impact on factor returns and real wages also demonstrates the negative effect that NAFTA produces in Central America relative to the NAFTA partners. The rate of return to capital increases slightly in the U.S. and more so in Mexico, but it falls throughout the rest of the region. All U.S. and Mexican labor categories gain with NAFTA (except for a large fall in Mexican rural wages in comparative statics), while all Central American labor lose with NAFTA (except for a slight rise in rural wages). The movement in urban wages is largely a function of the rise in two-way trade in most manufacturing goods between the U.S. and Mexico due to NAFTA. NAFTA, meanwhile, generates a decline in exports, output, and wages in these same sectors throughout the rest of the Central American region, particularly in low wage manufacturing.

The Post-NAFTA Record

Apparel exports from the CBI countries grew rapidly, after the signing of the CBI. But the preferential access of Mexico under NAFTA has already threatened that continued growth. Table 1 and figures 2,3, and 4 below show how NAFTA has enabled Mexico to increase its share of regional exports to the U.S. in several key apparel products.[5] Mexico arguably already has an advantage in terms of proximity to the key Southern California market, the relative attractiveness of the border infrastructure, and the ability of U.S. managers to live on the U.S. side and work on the Mexican side of the border. The additional advantages under NAFTA have clearly tipped the balance of incentives toward Mexico and away from the poorer CBI countries.

In the five-year period following NAFTA, from 1994 to 1998, total U.S. imports in these three important categories of textiles and apparel from these countries increased from just over $ 5 billion to nearly $ 12 billion, an annual average growth rate of more than 18 percent. Over that period, Mexico's share has increased from 31 percent to more than 47 percent, reflecting a growth rate of more than 28 percent, more than double the 12 percent growth rate for the CBI countries.

Table 1 below focuses more narrowly on Mexican exports in the pre- and immediately post-NAFTA periods. Here we have disaggregated to nine specific products, each with 1996 export values in excess of $ 30 million, and a total value of $1.8 billion. We see that exports of these apparel products accelerated after NAFTA, from 20 percent to 30 percent annual average growth.

In addition to a phenomenal growth in exports from Mexico shown in Table 1, Figures 2-4 below show a clear pattern of increased apparel exports to the U.S. from Mexico after NAFTA, at the expense of the market shares of nearly all CBI countries. Although this impact is just as predicted by economists, it is an impact that was not anticipated and certainly not intended by proponents of NAFTA. Current legislation offers an opportunity to correct these unintended, negative impacts on the economies of the CBI countries.

Table 1

Mexican Exports to the US: Apparel Products (minimum 1996 value: US$ 30 million)			
Product Description	Growth Rate 1990-1993	Growth Rate 1994-1996	Export Value 1996 (in current US$)
Men's and boys' clothing, n.e.c.	19.2%	54.1%	$ 38,699,651
Women's and children's underwear	9.2%	12.3%	$ 71,910,390
Men's and boys' underwear and nightwear	42.4%	49.4%	$ 87,742,218
Bras, girdles, and allied garments	6.5%	9.5%	$ 182,687,632
Women's and misses' blouses and shirts	25.2%	51.1%	$ 190,692,280
Men's and boys' shirts	63.4%	56.3%	$ 198,022,418
Sporting and athletic goods, n.e.c.	2.4%	18.6%	$ 210,040,541
Girls' and children's outerwear, n.e.c.	9.7%	27.5%	$ 343,551,776
Men's and boys' trousers and slacks	18.7%	21.1%	$ 522,740,032
Sum			$ 1,846,086,938
Non-weighted average growth rates	21.9%	33.3%	
Weighted average growth rates	20.2%	29.4%	

Source: Data base from the NAID Center. USA-Mexico and author's calculations

Figure 2

Share of Exports to the US by Country
(Men's and Boys Coats... Customs code 841)

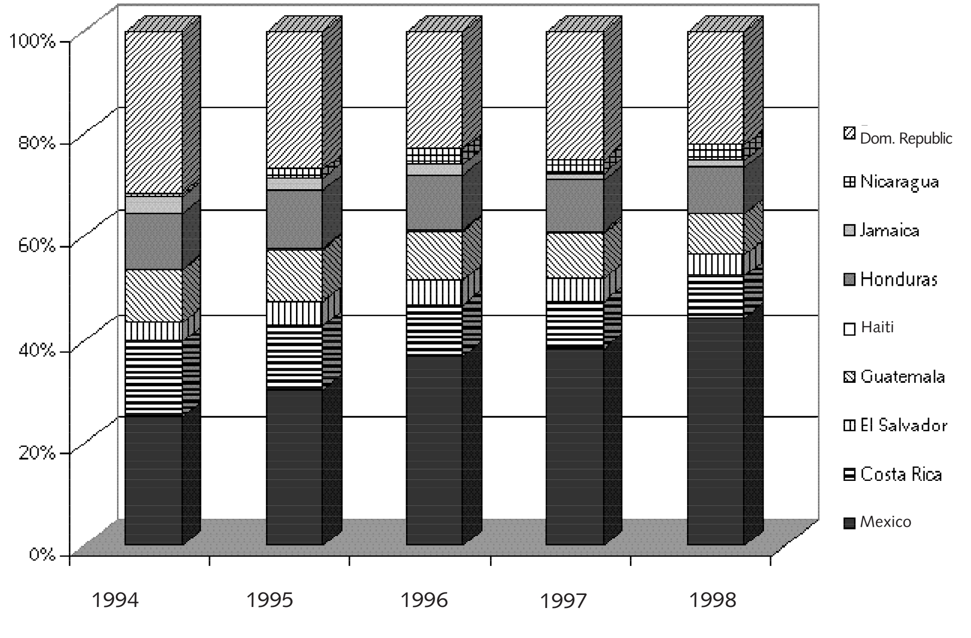


Figure 3

Share of Exports to the US by Country
(Women's and Girl's Coats... 842)

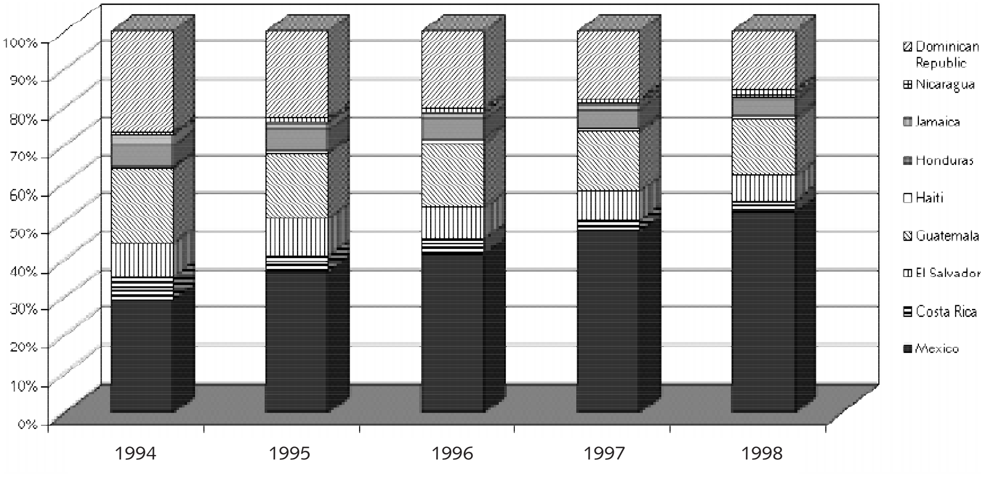
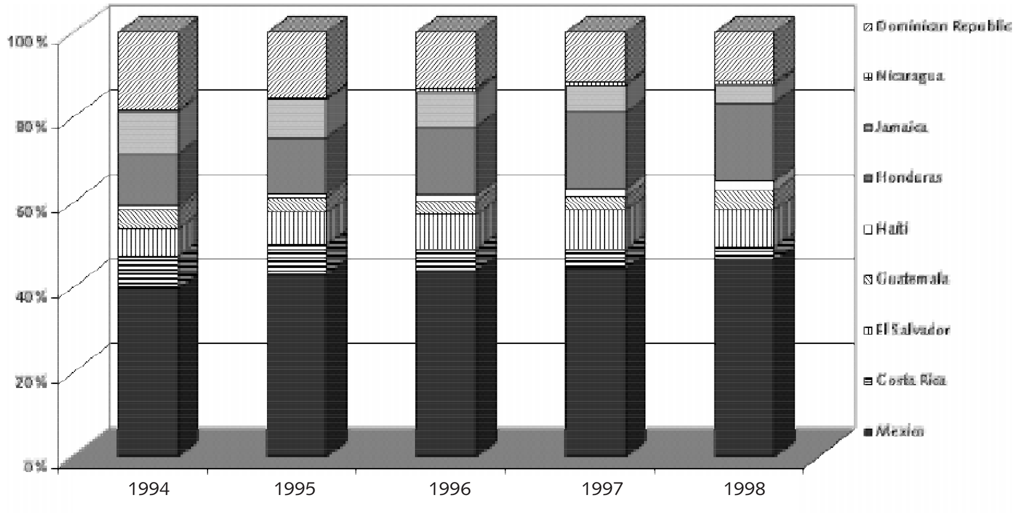


Figure 4

Share of Exports to the US
(Articles of apparel... Category 845)



The loss of Central American apparel market share relative to Mexico has also had a series of implications for U.S. exports to the region, as well as the ability of consolidating stronger bonds between U.S. and Central American producers that could help both regions face future global competition. In particular, the post-NAFTA record has shown a slow down and even decline of U.S. apparel exports to Central America, while exports to Mexico have been growing at a faster level. This is indicative of a declining complementarity of production and consumption patterns between the U.S. and Central America. More importantly, U.S. textile exports to Mexico have taken off at a phenomenally accelerating rate, while U.S. textile exports to Central America have actually begun to decelerate. This is a much more worrisome indicator that Mexico is surging past Central America as the primary growth zone for cross-border production activities with the U.S. in the garment-textile cluster. This is not in the interest of the U.S. for two reasons. First, it is not in the interest of the U.S. for Central America to lose an opportunity to also consolidate a garment-textile partnership that can enhance its ability to compete globally and expand employment. Second, it is not in the U.S. interest for U.S. textile producers to miss the opportunity to also develop a strong partnership with Central American producers, as they are doing with Mexico, increasing the ability of U.S. producers to also compete globally and expand employment.

Table 2 below shows that, with the exception of the Mexican crisis year of 1995, U.S. exports of apparel products to the CBI countries have been slowing down. Particularly in textile and apparel trade, imports and exports increase and decrease together, as U.S. components are assembled in the CBI countries and re-exported to the U.S. Thus the slow-down indicated here is a mirror image of the slow-down in the share of regional exports to the U.S. from CBI countries seen earlier. The most disturbing figure, of course, is the actual reduction in the value of apparel imports overall and in four of the five products charted here. While the current problems in the CBI countries are much more than just trade and investment diversion from NAFTA, NAFTA parity for CBI countries is clearly an appropriate starting point in crafting U.S. contributions towards solutions.

Table 3 and figure 5 present the information on U.S. textile exports to Mexico and Central America. The most striking trend that is revealed from this data is the explosive growth in U.S. textile exports to Mexico since 1995. Not only has this period seen a growth of nearly 1 billion dollars in additional exports, but the growth rates have continued to accelerate year after year. U.S. textile exports to Central America, on the other hand, while also growing throughout the 1990s, have not nearly kept up the pace of the growth of exports to Mexico. The most recent evidence actually shows a slight deceleration in growth just as Mexico continues a sharp acceleration.

Table 2

US Exports of Apparel to all CBI Countries (Millions of US current dollars)								
Description	Code	1992	1993	1994	1995	1996	1997	1998
Apparel of textile fabric	845	330	425	477	684	829	1,005	985
Clothing accessories, textile or knit	846	174	252	298	511	712	847	1,108
Men's and boys' coats and jackets, textile, not knit	841	412	541	643	611	646	821	776
Women's and girls' coats and capes, textile, not knit	842	266	304	342	348	354	400	370
Women's and girls' coats and capes, textile, knit	844	155	176	178	204	222	271	225
Growth rate from previous year								
Apparel of textile fabric	845		28.8%	12.2%	43.4%	21.2%	21.3%	-2.0%
Clothing accessories, textile or knit	846		44.8%	18.3%	71.5%	39.3%	18.9%	30.9%
Men's and boys' coats and jackets, textile, not knit	841		31.3%	18.9%	-5.0%	5.7%	27.2%	-5.5%
Women's and girls' coats and capes, textile, not knit	842		14.3%	12.5%	1.8%	1.7%	13.0%	-7.4%
Women's and girls' coats and capes, textile, knit	844		13.5%	1.1%	14.6%	8.8%	22.0%	-17.0%
Unweighted annual growth rate, all products			26.6%	12.6%	25.3%	15.4%	20.5%	-0.2%

Note: For 1997 and 1998, totals are reflated by dividing the available data for the eight largest regional importers by their share of 1996 imports, which was 95%.
Source: *www.ita.doc.gov/industry/otea/usfth/cbic.e-i*

Table 2 a

US Exports to Mexico of Code 845					
	1994	1995	1996	1997	1998
millions US$					
Apparel of textile Fabrics	351	465	509	772	914

Table 3

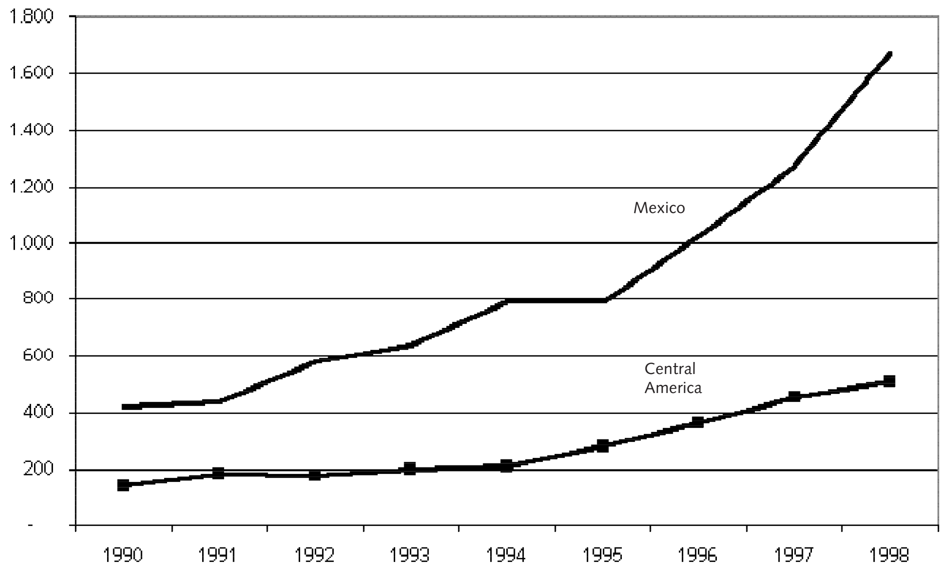
US Standard Industrial Classification Group 22 (SIC 22) * Exports to Central America and Mexico -1990 to 1998

US$ millions	1990	1991	1992	1993	1994	1995	1996	1997	1998
Mexico	422.6	439.7	581.1	637.1	792.2	789.4	1,025.8	1,276.5	1,668.8
Central America	138.6	182.2	180.1	198.6	212.3	283.5	365.8	453.7	511.4
Costa Rica	60.4	74.7	77.7	81.4	88.0	70.5	73.1	74.6	78.4
El Salvador	5.9	8.6	13.8	20.9	23.3	62.1	98.9	143.9	153.2
Guatemala	19.0	28.4	34.6	40.3	32.5	41.7	54.7	53.5	60.1
Honduras	24.9	37.0	27.1	30.9	43.9	86.1	117.8	157.4	197.8
Nicaragua	0.5	1.5	2.4	1.8	2.2	4.5	3.7	4.0	3.4
Panama	28.0	31.9	24.5	23.2	22.4	18.5	17.6	20.4	18.5

* SIC 22: Textile Mill Products

Figure 5

US Standard Industrial Classification Group 22 (SIC 22) * Exports



III. Potential U.S.-CBI Industrial Complementarities: Textiles and Garments

Economic research has traditionally approached the issue of comparative advantage and trade from the perspective of the national economy. As economic integration forges bonds among regional products and, in some cases, labor markets, it is increasingly necessary to look at the comparative advantage of a region, in international competition with other integrated regions. For instance, an obvious question would be how does NAFTA help North American regional producers better compete with integrated production from Asia and the European Union? [6] To summarize this body of technical work briefly, the underlying assumption is that increasingly open world capital markets have left a country's labor force as the primary determinant of comparative advantage. Thus the focus here is on labor of different skill levels, related to educational attainment.

Goods today, particularly complex manufactured products, require numerous fabrication and assembly steps. Each of these steps may require different labor skills. Economic integration allows these different processes to be accomplished in different locations, in order to lower the cost of each stage of production. Economies with different labor skill profiles would be the lowest cost locations for these different production processes, once trade barriers have been removed. On the one hand, this means some parts of the production process that had been done at a higher cost in the U.S. would be moved abroad, if the cost savings exceed the transportation costs. On the other hand, lower costs of production overall allow goods produced in the integrated North American market to be more competitive against similar goods produced in Europe and Asia, increasing U.S. sales and thus increasing the demand for labor of all types used in the various countries.

Thus it is seen that the process is a positive sum game, with a combination of: (1) reshuffling production locations, which might result in an initial decrease in U.S. production and a corresponding increase in production in partner countries, and (2) increased efficiency leading to greater demand and production levels, resulting in more of the "right kind of production" in each country. Where unemployment rates are high, this would translate into more jobs; with low unemployment, the primary impact would be to raise wages.

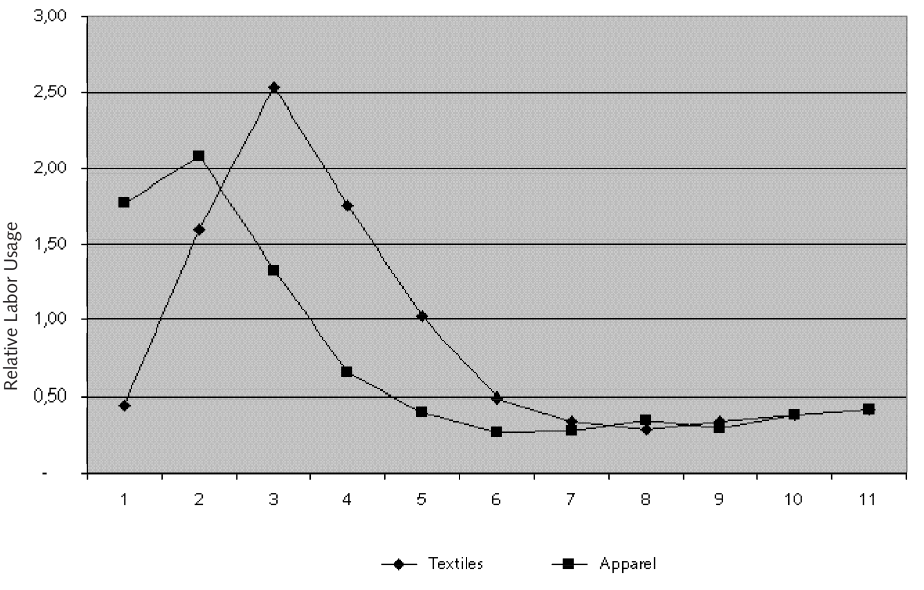
The second stage of the research clearly shows that North American integration through NAFTA improves regional comparative advantage in some products. However, it is also clear that unskilled labor is not as abundant in Mexico as it is in Asian countries like China, Indonesia, and several in South Asia. Thus the comparative advantage of the region (areas in which integrated production will lead to cost savings) is in transportation equipment, non-electrical machinery, and other capital goods, as opposed to consumer goods.

The next question to ask would be if an extension of NAFTA to the CBI countries could further expand North America's comparative advantage. Several CBI countries have larger shares of low skill labor than Mexico, and these include the largest labor forces in the region, in Guatemala, Haiti, Honduras, El Salvador, and the Dominican Republic. The total labor force of the 10 CBI countries for which data were available (about 18 million) is still smaller than that of Mexico, but they would contribute a different mix of skills to the expanded regional labor force. In particular, the types of labor skills available in the CBI countries correspond more closely with those required for production of apparel, textiles, and miscellaneous manufactures (for instance, toys and sporting goods), areas in which Asia exporters dominate the U.S. market. In the absence of further policy action, this dominance will increase, as the provisions of the Multi-Fiber Agreement (MFA) are phased-out by 2005 as part of the Uruguay Round WTO accord. In some ways, the appropriate policy choice is the lesser of two evils. Freer global trade is extremely important to U.S.

exporters, but will hurt U.S. producers who compete with imports. The U.S. garment and textiles industries are prime examples of import substitutes that must cut cost, rationalize production, and carve out appropriate niches to survive the onslaught of global competition in the next 10 years. No economic policy can preserve the industries in their current state, given the forces that have been set in motion by the WTO accord. However, granting NAFTA parity to the CBI countries would allow a rationalization of the industry, in which outsourcing in some area prevents job losses in others. Cost cutting, through the integration of production and markets, will create a leaner, stronger regional industry that can better survive enhanced global competition. At the same time, other benefits are generated for the U.S. and CBI countries, as detailed below.

Figure 6

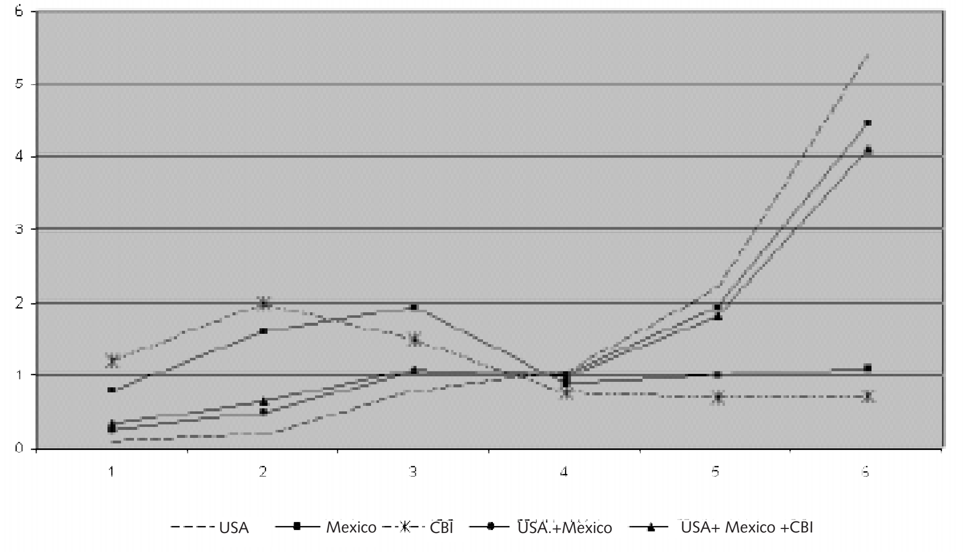
RELATIVE LABOUR USE BY SKILL TYPE: SELECTED NONDURABLE MANUFACTURING



Textile and particularly apparel production intensively use workers with relatively low skills. The U.S., with little low-skilled labor relative to capital, land, and skilled workers, pays relatively high wages to its low skilled workers, reducing the competitiveness of those products on both the domestic and world markets. Protection of the domestic market under the MFA has helped to preserve the U.S. industries at their present size, which is much reduced after a period of trade liberalization in the 1980s. As protection from imports from countries with relatively more numerous and thus lower cost low-skilled labor declines, the U.S. industry will face more tough choices. Rather than competing with lower U.S. wages (either by cutting wages across the board or by becoming increasingly reliant on legal and undocumented migrants from low wage countries), the various sub-products and processes up among the countries of North America should be split according to cost conditions (including but not limited to labor costs). In such an integrated market, falling

costs would lead to more overall production, production that is more appropriate to each member economy, and perhaps more economic activity and even employment in each country, including the United States.

Figure 7

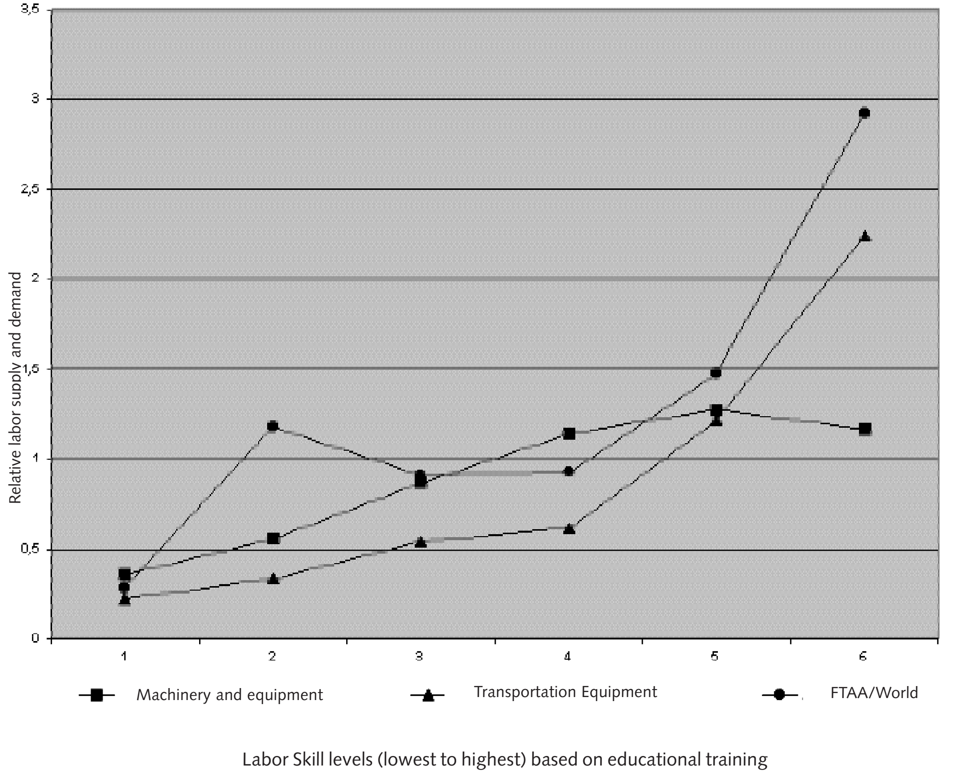


As shown in the figure above, adding the 17 million person labor force of the CBI countries to the more than 170 million workers in the U.S. and Mexico has only a marginal impact on regional relative labor endowment and thus regional comparative advantage. However, those who focus exclusively on relative economic size, as measured by relative GDP in U.S. dollars would conclude that the CBI countries are insignificant (less than one percent), relative to the combined U.S. and Mexican economies. We believe that the focus on the relative size of the labor forces is more revealing as to how further market and production integration with CBI countries under NAFTA parity would impact the U.S. economy. Such integration would lower the costs of producing certain labor-intensive components and final assembly, both in garments and textiles and in other manufacturing sectors as well. The impact will be significant, but not huge. The cost gap for North American production in those areas, relative to Asia, will be diminished, but not eliminated or reversed.

As a final caution, it should be stated again that the comparative advantage in global trade, even of a broader integration area covering all of the Americas (such as the proposed Free Trade Agreement for the Americas, or FTAA) would still be in goods that use relatively more skilled labor, as seen in figure 8. But there is no doubt that closer ties with the CBI countries would make the regional garments and textiles industry more competitive in domestic and world markets, so that a larger fraction of the regional industry would be saved after 2005.

Figure 8

PRO-FTAA SECTORS



The U.S. is the most important source of foreign investment in the Caribbean Basin, with assets in the Caribbean Basin Economic Recovery Act (CBERA)-eligible Caribbean countries totaling almost $43 billion, although most of this is concentrated in finance (excluding banking), insurance, and real estate. Investment in this sector in the Netherlands Antilles alone equals almost $ 26 billion. U.S. cumulative investment in Central America (other than Panama) totaled roughly $ 2.8 billion in 1997.[7] Investment in manufacturing is quite low and is still concentrated in food products. Export-assembly operations, however, are rapidly gaining importance. The value of export-assembly products imported into the U.S. from the Caribbean Basin doubled between 1991 and 1996, to $ 3.5 billion, of which Central American products accounted for 30 percent. U.S. investors have played a particularly important role in developing the apparel export industry in the Caribbean Basin, mainly due to special provisions allowing for production-sharing arrangements. In both Jamaica and Honduras, for example, U.S. apparel companies accounted for roughly one quarter of total direct investment in the sector in 1991.

IV. How Does Extending NAFTA Parity to the CBI Countries Benefit the U.S.?

One view of the globalization process holds that some degree of industrial hollowing in the U.S., as labor-intensive products and processes move overseas, is inevitable and good for the long-term health of the economy. Yet it matters where those firms relocate. For instance, consider a firm deciding whether to locate a new production facility in Honduras or Hong Kong. There are externalities that may make the location in Honduras preferable from the perspective of U.S. society, all else being equal. A firm located in Honduras would be more likely to source capital and intermediate goods (consider also finance, real estate, insurance and other services) from other U.S. firms, while a plant in Thailand may source more locally or regionally in Asia. Additionally, if the output of the plant is itself an intermediate good, then the U.S. affiliate may be supplying high-quality, low cost components for Asian firms competing with American firms in final product markets. In terms of factor payments, the marginal propensity of CBI workers to spend their wages on American goods is much higher than the propensity of Hong Kong workers, but unless these expenditures are specifically on this firm's output, they will not be taken into account in the location decision. Thus locating production facilities in CBI countries instead of Asia will raise exports of U.S. capital goods, intermediate goods, business services, and consumer goods.

To summarize, NAFTA parity for the CBI countries will enhance U.S. competition in global markets by reducing labor costs, by allowing American firms to exploit Honduras' comparative advantage in labor intensive products and processes. "Leakage" is minimized due to the strong existing consumption and trade linkages between the countries. Free trade with Honduras exploits complementarities in resources, labor skills, and climate. Considering CBI countries as a market is less important in the short run compared to their value as a production base, and issues of macroeconomic stability, industrial competitiveness, and political stability are important. In the long-run, as investments and trade boost wages, growth in the market for U.S. capital, intermediate, and consumer goods may prove to be the biggest pay-off for the U.S.

Increased incomes and economic activity in the CBI countries have even more potential benefits for the U.S. In addition to the increased demand for U.S. exports from firms and consumers in the CBI countries, and the increased demand for the U.S. components used in the integrated industries, economic development will have implications for immigration and the drug trade.

Modeling on Alternative Future Scenarios

The previously mentioned modeling work produced results of a series of alternative scenarios of potential future paths of trade liberalization between the U.S., NAFTA, and Central America. One set of scenarios which have been discussed in policy circles are the establishment of separate free trade agreements (FTAs) between Mexico and the Central American Common Market and between the United States with the Central American Common Market. The results of modeling these scenarios indicate a likely significant expansion in intra- and extra-regional imports and exports for Central American countries. The impact of the aggregated effects of larger trade flows is evident in a substantial increase in GDP growth rates for all the countries in the region. Results show a growth in real GDP for Central American countries ranging between about 1% and 3% for the US-CACM FTA. The scenario corresponding to Mexico-CACM FTA (which is actually nearing completion) also produces positive impacts, although they are more modest. This is a direct consequence of the differential sizes of the Mexican and US economies.

Another alternative -NAFTA-CBI Parity, combined with a Mexico-CACM FTA- produces the most positive impacts for all countries. This means that for Central American countries the most benefits are produced by the integration with the US, while there are also small additional effects of the simultaneous integration with Mexico. In this scenario there is not any evidence of trade diversion, nor retraction in the rate of growth of real GDP. For the US, the resulting increase in imports of fruit and vegetables are more than compensated by a much larger increase in exports of grains. There is also a very important increase in Central American countries' imports of industrial goods (including light manufacturing, capital goods and consumer durables) which is associated with an important increase in US exports in the same sectors.

The analysis of the results makes evident that the best scenario for all countries is the extension of trade benefits throughout NAFTA and the CBI area. The increase in GDP, for the scenario with potential externality effects is the 0.3% for all countries combined, with individual values ranging between 1% and 3% for Mexico and Central American countries, and 0.08% for the United States.

V. Conclusions: Clearing Up Misconceptions about the Impact of NAFTA Parity on the CBI Countries

Would extending the NAFTA hurt CBI countries?

1. The argument that the CBI countries will experience a painful adjustment period is based upon a faulty assumption. Some argue that the costs of extending the NAFTA will be high because the U.S. will expect several economic concessions in return for CBI countries' privileged access to the U.S. market. That, however, is not the context in which the legislation is currently being considered. Intellectual property rights, lowering of trade barriers, and other possible concessions are not part of the present negotiations. They are, thus, irrelevant in the current context.

2. It is wrong to think that all the North and Central American apparel and textile industries will necessarily be decimated in 2005. A more careful examination of the apparel industry suggests a broader range of possible scenarios. In articulating the causes of the rapid growth of apparel investment and production in the Caribbean Basin, many did not include perhaps the most important one—proximity. The U.S. apparel industry relies not only on low cost production, but also on locations that are proximate enough for quick turn production. Quick turn -meaning rapidly moving from the design stage to the assembly stage- is required by most retailers. Asian locations are significantly disadvantaged in that regard. Any cost advantages of producing in China are eliminated if the manufacturer must pay the high price of air shipping in order for US firms to obtain finished goods in time for their shipment to retailers. Because of the still high costs of rapid transportation, many segments of the apparel industry in the U.S. and in locations near it will survive Asian competition.

3. Transshipments have not been a problem for Mexico and would not pose a problem for CBI countries. Some argue that any benefit to CBI countries would be limited because most goods entering from that region would be transshipments from Asia. Why, then, there haven't been massive transshipments from Mexico, whose restrictions on apparel imports are much lower than those in the U.S.? Strict rules of origin in the NAFTA define which goods receive NAFTA treatment and which are treated as non-NAFTA imports. The rules of origin require that the fabric and most fiber originate within the NAFTA region. As a result, transshipments are strictly regulated. So long as the rules of origin governing the NAFTA are extended to CBI countries in granting NAFTA parity, concerns about transshipments are unfounded.

4. Remittances to CBI countries are not likely to lessen, and do not pose a challenge to NAFTA parity. In arguing that extending NAFTA treatment will hurt CBI countries, some argues that remittances they receive from apparel workers in the U.S. will be reduced because there will be fewer apparel jobs in the U.S. It is true that most apparel assembly workers in the U.S. are immigrant workers, and most are from Mexico or Central America. This does not, however, mean that most immigrants sending remittances are garment workers. Most are not. Most are employed in a variety of blue-collar occupations, most paying far more than garment assembly work.

5. Extending the NAFTA will help, not hurt CBI countries. Some argue that rather than NAFTA Parity, the CBI region needs increased aid and debt-forgiveness rather than trade policy measures. We certainly do not disagree that debt-forgiveness and increased aid would help the economies devastated by Hurricane Mitch recover more quickly. We maintain, however, that trade policy measures such as extending the NAFTA will have stronger positive economic development consequences. Limiting the development of the apparel industry in CBI countries to 807 assembly production with its minimal economic spillover effects certainly does not reflect a desire to aid the struggling economies in our hemisphere that are plagued by weak industries. Granting NAFTA parity in apparel would promote the strengthening of CBI countries' apparel industries and would have no visible harmful effects on the region.

Would extending the NAFTA-Parity Benefits help CBI countries and the U.S.?

1. Compared to NAFTA benefits, the CBI is not enough to stimulate industrial development in the Caribbean. Apparel trade in the CBI region is highly constrained, restricted almost exclusively to goods that were merely assembled in CBI countries. CBI garments enter the US as "807" goods-goods made of US fabric, cut in the US and assembled in the CBI countries, and only these assembled goods are privileged under the CBI. Those that were, for example, cut, sewn and finished in Honduras would not receive CBI privileges. Hence, the CBI encourages the development of U.S. and foreign *assembly plants*, not manufacturing plants in the CBI region.

2. Industrial development, not simply growth, generates economic development. Assembly plants do generate economic growth (higher GDPs), but do not necessarily lead to industrial development or economic development. Assembly plants do not typically lead to greater industrial integration, stimulating minimal technology transfer, and they do not offer large amounts of quality jobs. Industrial development requires more suppliers and industry services, which the CBI currently discourages.

The economic development implications of the current CBI policy are the creation of a limited number of low-skill jobs with little likelihood of upward mobility for workers. Moreover, assembly plants in the region are often located in export processing zones that are often exempt from paying any taxes. Hence, the state receives no direct income from their operations. The jobs created are low-skill assembly operations. Few skills are learned on the job that could be transferred to other occupations. There are few opportunities for upward mobility within the factory and in the industry generally.

3. The key reason why Mexico is now a preferred investment location is not only the differences in tariffs, costs or quotas, but especially the freedom from 807-type production. Mexico's apparel industry has a considerably more favorable outlook now because of NAFTA. Rather than being restricted to apparel assembly by 807 stipulations, any goods produced wholly in the NAFTA region are duty- and quota-free. Apparel can be designed in Mexico, cut in Mexico of US fabrics, and finished in Mexico, allowing apparel manufacturers

more freedom to locate production facilities according to comparative advantages. As Mexico is on its way to becoming a full partner with garment and textile producers in the U.S., this also helps the more competitive and higher wages producers in the U.S.

4. Because it encourages the working of comparative advantage within North America, the NAFTA strengthens the Mexican apparel industry, whereas the CBI stunts that region's apparel industry. The US has a comparative advantage in textile production and in apparel design due to high labor productivity. CBI countries and Mexico have comparative advantages in other segments of apparel production, including sewing, cutting, and laundering. US trade policy, specifically the CBI, does not permit CBI countries to capitalize on these comparative advantages, restricting them to apparel assembly. Mexico, in contrast, has seen the growth of sewing shops, apparel services, and suppliers including industrial laundries, dyehouses, cutting firms, legal services and financial services.

5. Strong, integrated apparel and textile industries in North and Central America will survive 2005 better than a weak, fragmented industry. The NAFTA has stimulated the development of a more integrated apparel production network through comparative advantage. If the NAFTA is extended to CBI countries, the CBI region will also have the opportunity to develop a more densely integrated apparel industry. The development of an integrated industry in the region is essential to surviving the influx of Asian imports in 2005. Production sharing arrangements with Mexico make US firms highly competitive. They are able to reduce total costs by utilizing more efficient Mexican suppliers and apparel services and more competitive US textiles. Productivity increases as Mexico's industry grows, enhancing both the competitiveness of US textile firms and the Mexican industry. Hence, both the US and Mexico will continue to improve their competitive position through tighter industry integration. By extending NAFTA treatment to CBI countries, their competitiveness with respect to Asia can similarly be encouraged.

6. Until NAFTA parity is extended to the CBI region, the only apparel work done in the region will continue to be assembly work. Granting NAFTA parity now allows those participating countries several years to benefit from freer trade as Mexico has. NAFTA parity would create incentives for other types of apparel–related production work to develop. Moving from assembly work towards a more integrated industry within the region offers the opportunity for economic and social development in the CBI countries. Assembly operations currently offer them very little benefit.

Notes

[1] Support for this research was provided from INTAL in order to contribute to the legislation process over this issue at the U.S. Congress.

[2] A separate proposal to provide debt relief for Nicaragua and Honduras remains under consideration, however.

[3] See Hinojosa-Ojeda et al [1996] and [1999] as well as articles in Hinojosa-Ojeda, Raul and Antonio Yunez-Naude [1999].

[4] This "static" result is meant to measure only the direct effects of a tariff reduction and is not meant to represent the impact of a more realistic "dynamic" scenario based on enhanced productivity growth and macroeconomic expansion.

[5] Data from *www.ita.doc.gov/industry/otea/usfth/top80cty* (the U.S. Department of Commerce International Trade Administration). The three products selected were the only apparel categories in the top 20 U.S. imports from all these countries.

[6] Note that there is no formal economic integration agreement covering all of Asia, in a way comparable to the EU or NAFTA. With the exception of the Association of South Eastern Asian Nations (ASEAN) free trade agreement, which is still in the early phases of implementation, economic integration in Asia is driven by flows of private investment, trade, and technology, responding more to market opportunities than to preferential treatment of regional partners.

[7] Source: U.S. Department of Commerce, Direct Investment Positions for 1997, *http://www.bea.doc.gov/bea/ai/0798dip/maintext.htm*

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Contents

Colombia and the NAFTA

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Summary

This paper presents an overview of the most recent trade policy reforms in Colombia and a brief analysis of their potential effects on this country's trade flows. This set the stage for the main objective of this paper: a preliminary general equilibrium assessment of the economic effects of Colombia's hypothetical accession to the North American Free Trade Agreement. The results indicate that such an arrangement, dubbed here NAFTA+, has significant implications for Colombia, but very limited effects upon the NAFTA incumbents, the U.S., Canada, and Mexico. This follows intuitively from the size and proximity of the participating economies, but the sectoral and employment adjustments in Colombia are complex and would be difficult to anticipate from heuristic, partial equilibrium, or aggregate analysis. Generally speaking, Colombia would be a significant beneficiary of a NAFTA+ agreement, but the ensuing adjustments intensify traditional patterns of comparative advantage for this economy and, absent other co-ordinated policies, might undermine modernisation and sustainable growth. These results have implications for many NAFTA aspirants, but should not be generalised too freely. Each prospective entry should be evaluated by the same detailed empirical analysis as it is proposed for the Colombian case.

I. Introduction

The signature of the NAFTA regional trade agreement and the recent positive results recorded for MERCOSUR has created expectations of further economic integration in the Americas. In December 1994, presidents from 34 American countries met to discuss the possibility of creating by the year 2005 a Western Hemispheric FTA. This idea was again formulated in 1996 at a similar meeting in Cartagena, Colombia.[1]

Among the various possible regional agreements, those of particular interest to Colombia, involve the joining of the Andean Pact and MERCOSUR, or the southern extension of NAFTA.

While the benefits of multilateral trade liberalisation are now almost unconditionally accepted, those of bilateral, or regional, agreements are not. The main

objection refers to the possibility that trade diversion might be larger than trade creation. Besides, it should be noticed that, in the context of trade liberalisation, aggregate results are relatively easy to predict. The removal of import distortions through enhanced comparative advantage and expanded trade, promotes greater efficiency and increases welfare. The structural adjustments which the economies undergo are more uncertain, but, given that trade policy reform usually creates winners and losers it might be important for its sustainability in the long term to have some ex-ante detailed sectoral information on the possible outcomes. In fact, sectoral results are essential in the analysis of the real structural adjustment and reallocations occurring in response to policy change. For it is individual sectors that seek import protection, aggregate real income or equivalent variation measures do not usually play a decisive role in the formulation of trade policy. In order to implement sustainable reforms is then crucial to have detailed information on sectoral adjustments and other trade-offs not discernible at the aggregate level.

For these reasons, the preferred approach to evaluate the possible Colombian entry in a regional trade agreement, or indeed any similar policy change, would be a detailed empirical analysis based on a Computable General Equilibrium (CGE) model. This has two important advantages for policy makers. First, it permits more accurate and timely anticipation of potential gains, losses, and their implication for negotiation and adjustment assistance. Second, this kind of analytical support can greatly facilitate the design of co-ordinated domestic policies to limit the losses and more fully realise the gains of more liberal trade.

The main objective of this paper is to offer this sort of quantitative analysis of Colombian accession to NAFTA. A four-country multi-sector CGE model is used to assess the effects of this regional agreement. The results indicate that substantial adjustments will indeed take place as a result of Colombian accession to the existing regional pact, but these are generally confined to Colombia itself. Its accession is more expansionary than diversionary from a trade prospective, yet ensuing adjustments intensify traditional patterns of comparative advantage for this economy and, absent other co-ordinated policies, might undermine modernisation and sustainable growth.

The quantitative analysis of this paper is a further addition to a quite large literature on trade policy evaluation.[2] Various studies have directly considered the Latin American region [3] and our work contributes to this body of research by explicitly assessing alternatives for Colombia and by modelling quantitative restrictions, which have been overlooked in previous analyses.

One additional objective of this paper is to present the course of the recent Colombian commercial policy and its related trade flows. This serves the purpose of putting into perspective the subsequent model simulations and it helps interpreting its results.

We should also add that although the political feasibility of a regional trade agreement between NAFTA and Colombia now appears rather low, the analysis presented here is motivated by various reasons, which are just mentioned in this introductory section, and fully documented below. Firstly, NAFTA is Colombia's main trading partner as both an imports source and exports destination. Secondly, the recent emphasis put on regional integration with southern partners (Andean Group, Mexico, MERCOSUR), although it may make political sense, it is not fully convincing from an economic point of view. Southern markets are still too small and the "open regionalism" idea that appears to motivate these South-South agreements, seems a shift at the regional level of the infant industry protection strategy. Although some recent economic analyses re-evaluate this development strategy,[4] various factors may undermine its effectiveness in Latin America. Among these are high labour costs, moderately low skill levels and a not too clearly focused public investment policy. Finally, a study of a regional integration with the North,

although hypothetical, may be a useful learning exercise that may help to re-focus the Colombian commercial policy strategy and priorities.

The paper is organised as follows. The next Chapter presents a brief overview of the most salient commercial policy measures adopted by the Colombian government. It also details the latest evolution of Colombian trade flows. Chapter 3, presents a summary of the main features of the model. This is followed by a description of the model data set and of the sources used in its construction. A preliminary examination of the crucial data used to calibrate the CGE model concludes this Chapter and complements the analysis of Chapter 2. Chapter 4 presents the simulations and results of the CGE model. Some brief conclusions are reported in the last Chapter.

II. Recent commercial policy and trade flows in Colombia

Colombian commercial policy

At the beginning of the 90's Colombia had the highest levels of tariffs in the Andean region (36.6% against 17% for Venezuela, 9.8% for Bolivia, 32.8% for Ecuador and 32.1% for Peru). The model of industrialisation through import substitution was showing its serious limitations and the rate of growth was falling.

The low competition level of the domestic market protected by high tariffs had various consequences. It increased the monopolistic (or oligopolistic) structure of national industries; it inflated its profits margins with adverse effects on income distribution; it expanded the scope and size of rent seeking activities; high costs for imports also reduced the international competitiveness of domestic products creating an implicit anti export bias; finally, high tariffs created a strong dependency of the government on these taxes revenues, adding problems of uncertainty and instability.

This situation dramatically changed in correspondence with the election of president Gaviria in 1990. The new administration found itself in a favourable position to alter the Colombian commercial policy and, with it, its whole development strategy. The country had enough international reserves to allow a reduction in the tariff and in the connected revenues, and the low level of the peso, granting enough protection for the domestic industry, made this reduction politically feasible.

The primary objectives of the new policy, aptly named "Apertura", where as follows. Firstly, stimulate growth. A reallocation of resources towards more productive uses accompanied with a weakening of the oligopolistic structure of the domestic industries was expected to create new growth opportunities, additionally these were enhanced by increased private capital inflows. A second objective was increasing equality. A specialisation towards labour intensive industries of the Colombian economy should have helped with this objective; besides a clearer trade policy should have decreased rent seeking activities and their negative income distribution effects. Lastly, the new strong structure of import and export flows should have helped Colombia to integrate its economy with that of the American continent, or even with global markets.

The main steps in the process of liberalisation were the elimination of quantitative restrictions (achieved by November 1990 [5]) and the tariffs reduction. This was done in two phases. Firstly, a program of abatement of the average tariff level from 36% to 16% in 4 years and the parallel reduction in dispersion, was implemented. This did not work, initially importers were not convinced of the government's commitment and reduced their imports. These problems of credibility and uncertainty eventually forced the government to a drastic reduction in tariff levels (a shock not gradual reform) by the end of 1991. This ended the uncertainty and helped the increase in the import flows which compensated the loss in

tariff revenues (these represented 30% of the government budget). The final result was an 11% average level of tariff.

The "Apertura" policy package not only affected trade taxes, it also included other adjustments. These ranged from regulating trade issues, as anti-dumping and other unfair competition, to institutional reform, as the creation of a new independent Ministry of Foreign trade,[6] to the stipulation of International trade treaties. This last point was viewed as a means of gaining market access to Colombian exports, a way to push the supply side of the national economy. The first step was establishing an FTA with Venezuela in 1991 and the contemporary reviving of the Andean Pact. Colombia signed another FTA with Chile in 1993 and the Group of 3 treaty with Mexico and Venezuela in 1994. An agreement with CARICOM was reached in 94. Meanwhile the US and EU rewarded the countries efforts against drug trafficking activities with unilateral trade concessions. Colombia regarded itself as a possible future member of NAFTA.

These policies were almost reversed in recent years by the government. Emphasis was placed on reciprocity in all future negotiations. One main result was the implementation of a Common External Tariff (CET) in the Andean Pact, effective since February 1995. Yet many exceptions on capital goods, raw materials and agriculture were included. Soon these exceptions became a source of conflict among the members of the pact. The regional integration policy was continued, but it changed direction. The negotiation with MERCOSUR was viewed as the most important. This was to be a negotiation among blocks: the Andean Pact and MERCOSUR. This created many administrative and institutional delays and not much progress has been made. Besides, NAFTA lost importance because of drug-related problems and the Mexican peso crisis.

Recent Trade Flows

This Chapter briefly illustrates the recent behaviour of Colombian trade flows. The geographical and sectoral composition of these flows is presented so that a very elementary assessment of the 90's commercial policy can be given. The following data are also useful in explaining some of the simulation results presented below.

Consider first the geographic composition. For brevity, exports and imports with 9 trading partners are analysed: US, EU, Venezuela, Ecuador and Peru (as main partners in the Andean Pact), Chile, Mexico, Brazil and Argentina (as the main partners of MERCOSUR).

Two main features should be noticed in the figures shown in Annex II. Firstly (consider Figure 1 and Figure 2), among the main trade partners of Colombia the developed countries weigh the most with the US as important as 50%. Secondly, as a direct effect of the "Apertura" and of the bilateral agreements with the South, almost uniformly across the region import and export flows seem to shift towards the South. This second feature clearly appears when considering Figure 3.

Here it clearly appears that Venezuela, Ecuador, Chile, and Mexico show above the average growth rates for imports (average is represented by the column total), and that the first three countries have a growth rate superior to that of US and EU. The same even more striking is true for exports. It is also possible to notice that it takes some time for exports growth rate to pick up those of imports. This delay is what sometimes creates problems to policy makers: economies adjust slowly. The literature on supply response is though quite firm: a credible and lasting effort to increase the supply price of exportables (that is direct consequence of a trade liberalisation policy) is rewarded by large export response.

Consider now some compositional issues, see Figure 4 and Figure 5. For brevity, only the two major north and south Colombian trading partners are shown. In the graphs, the rightmost column labelled *% geo* measures the partner share of Colombian trade.

From these figures it clearly appears that manufacturing exports (what is normally considered non-traditional exports) to US had not increased their weight (the only sectors likely gaining is food products). On the contrary, notice the composition of exports to the Andean countries (only Venezuela is shown). Firstly, the weight of manufacturing is much higher and additionally is increasing. A sector especially dynamic has been light manufacturing. This picture does not change a lot when considering the other countries of South America.

When looking at the import side (consider Figure 6 and Figure 7) we notice again a difference in the weight of US with respect to other countries and especially in their contribution to capital goods imports. This is especially important because these goods incorporate new technology.

Overall it is possible to conclude that negotiating increased market access to North America should be of primary importance in the Colombian trade policy agenda. Although more attention has been recently given to an expansion towards the south of the continent, NAFTA, and the US in particular, remains a major export market and supplier of crucial capital goods. The idea of developing a regional southern American market without an immediate increased integration with more developed countries, which has been lately labelled as open-regionalism has some appeal but it also shows severe limitations. Firstly, as shown in the above figures, the southern market is still too small. Secondly, shifting the infant-industry idea at a southern regional level may be risky for two main reasons: high labour costs and relatively low skill levels. These may prevent a successful East Asian style export-led growth. Nevertheless, as shown above, some progress in South-South trade has indeed been made. A possibility of expanding non-traditional exports may arise. A clearer assessment of the above strategy with the analytical tools proposed here should be the next step in the analysis.[7]

III. A CGE model and database for NAFTA+

This Chapter presents a brief description of the computable general equilibrium (CGE) model and database used to simulate the welfare and resource allocation effects of Colombia's joining Canada, the United States, and Mexico in a free trade area (FTA). For readers interested in more details, a technical appendix is available upon request.

The CGE Model

The four-country CGE model is based on a three-country kernel, which has been used for several types of NAFTA appraisal [8] in the past. Typical of most comparative static, multi-sectoral, economy-wide models in use today, it simulates price-directed resource allocation in commodity and factor markets. They maintain detailed information on sectoral prices, output, trade, consumption, and factor use in a consistent framework, which also accounts for aggregates such as income, employment, and revenue. The present model differs from conventional CGE specifications in two important ways. First, it is a *detailed and complete four-country model*, so domestic supply, demand, and bilateral trade for the United States, Canada, Mexico, and Colombia are fully endogenous at a 19-sector level of aggregation.

The extent of price adjustments, as well as the volume and pattern of trade creation and trade diversion, are important factors in determining the ultimate welfare and resource allocation effects of multilateral trade policy. A second important feature of the model addresses these responses to FTA trade liberalization. The model employs differentiated product specification of the demand and supply in tradeable commodities. In

each sector of each country, domestic demand is constituted of goods which are differentiated by origin (domestic goods, imports from each FTA partner, and imports from the rest of the world). These goods are aggregated using a non-nested, constant elasticity of substitution (CES) functional form into a single consumption good for both intermediate and final use. This specification allows for substitution among origins in response to commercial policy and exchange rate changes. Demand for the 19 aggregate goods in each country is modeled using a linear expenditure system (LES). Also in each sector of each country, domestic production is allocated using a non-nested, constant elasticity of transformation (CET) functional form among differentiated destinations (domestic market, exports to each FTA partner, and exports to the rest of the world). This specification allows for substitution among destinations in response to commercial policy and exchange rate changes. Together, the above two trade specifications constitute product differentiation by country of origin and destination, allowing for intra-industry trade.[9] As such, the four countries maintain 12 pairs of 19-sector trade flows between them, governed by 12 endogenous price systems (U.S.-Canada, U.S.-Mexico, Canada-Mexico, U.S.-Colombia, Canada-Colombia, and Mexico-Colombia imports and exports). With respect to the rest of the world (ROW), each country faces import supply and export demand schedules, totaling four more price systems (U.S.-ROW, Canada-ROW, Mexico-ROW, Colombia-ROW imports and exports).[10]

Production takes place under constant returns to scale using constant elasticity of substitution functional forms, and all markets are perfectly competitive. In each domestic product market, prices are normalised to a fixed numéraire price index weighted by the base composition of sectoral final demand. On the external accounts, ROW exchange rates are assumed to be flexible while trade balances are fixed.

The CGE model was calibrated to an estimated 1992 social accounting matrix (SAM) for North America and Colombia discussed in greater detail in the next section. The calibration of the model to the SAM relied on a set of behavioural parameters equivalent to those described in Reinert, Roland-Holst, and Shiells [1994b] and making use of the non-nested elasticities of substitution among import sources estimated by Shiells and Reinert [1993]; the model also includes country-specific elasticities for Colombia adapted from recent studies.[11]

The SAM Database

The central data source for this paper was a 1992 social accounting matrix (SAM) for Canada, the United States, Mexico, and Colombia. Construction of the 1992 SAM began with the transformation of 1992 national accounts for each country into four separate macroeconomic SAMs. The Canadian macroeconomic SAM was constructed by mapping the macroeconomic data presented in two sources (Statistics Canada [1993a and 1993b]) into a matrix format. The U.S. macroeconomic SAM was constructed by transforming the U.S. National Income and Product Account (NIPA) accounts into matrix format. For the Mexican macroeconomic SAM, data from OECD [1992], Banco de México [1993], Instituto Nacional de Estadística, Geografía e Informática [1992], and International Monetary Fund [1993] were used. Finally, the Colombian macroeconomic SAM was constructed using data from official sources.[12]

Next, the individual macroeconomic SAMs were joined together into an integrated macroeconomic SAM for the four countries. This process was completed in three steps. First, the Canadian, Mexican, and Colombian macroeconomic SAMs were converted to 1992 U.S. dollars using yearly averages of market exchange rates from International Monetary Fund [1993]. Second, trade flows among the four countries were added to the

multi-country SAM and subtracted from the rest of the world account. Data on trade flows were taken from International Monetary Fund [1992]. Total Mexican trade was adjusted for maquiladora trade using data from Banco de México [1993], since these activities were not reflected in the Mexican national accounts prior to 1992. Third, factor service flows and capital flows among the four countries were added with the appropriate substractions from the rest of the world account. These flows were taken from U.S. Department of Commerce [June, 1992] and Statistics Canada [1993b].

The detailed sectoral accounts were constructed by disaggregating the commodity account rows and columns of the four-country macroeconomic SAM into 19 sectors. The disaggregated accounts include labour value added, property value added, indirect business taxes, value added taxes (for Mexico and Colombia), domestic final demand, imports, exports, and inter-industry transactions. This was done using 1990 Statistics Canada input-output accounts, 1987 U.S. Department of Labor input-output accounts, 1989 SECOFI (*Secretaría de Comercio y Fomento Industrial*) input-output accounts for Mexico, and 1992 input-output accounts for Colombia.

Sectoral trade flows were estimated using 10-digit HTS (Harmonized Trade System) data for the United States and 3-digit SITC (Standard International Trade Classification) data and official national data for all four countries. The former was obtained from U.S. Department of Commerce (USDOC), Bureau of the Census data tapes, and the latter was obtained from United Nations data tapes and national statistics. Sectoral trade within North America was estimated using the import data from these data tapes. Canadian tariffs were estimated from the 1990 input-output data, U.S. tariffs were estimated from the USDOC data, Mexican tariffs were estimated from data presented in General Agreement on Tariffs and Trade (1993), and Colombian tariffs were estimated from data provided by official sources.

Some essential data on the economic structure and protection rates of the countries modelled are shown in Table 1 and Table 2

This information on the general structure of production and trade will facilitate understanding the simulation results reported later.

The first table reports structural information on the US and Colombia.[13] The differences between these two economies appear clearly from inspecting this table: the US have a relatively small primary sector and a large service share of gross production, whereas 54 per cent of Colombian gross production is in primary and manufacturing sectors. US trade presents the typical pattern of intra-industry trade: notice the exact equal shares for imports and exports in the capital goods sectors (sectors 11 and 12). Conversely, Colombian exports are concentrated in the primary sectors and light manufacturing. Four sectors (Agriculture, Mining, Food Product, and Textiles) account for almost three-quarters of Colombian total exports. Its imports are also concentrated in manufacturing and a dependency on capital goods also emerges. The columns labelled *Vl/Vk* measure the ratio of labour over capital value added, this gives a measure of the returns to labour with respect to those to capital. Roughly we can expect that capital intensive sectors show a lower figure, as it is the case for *Electricity* and *Financial services* in the US or *Mining* in Colombia. The average higher values for the US than Colombia correspond intuitively to the higher labour returns of the northern country. The last four columns in Table 1 show Colombia exports by regional destination. As it was already pointed out above (see Figure 2), the US is the most important market, with its demand concentrated in primary sectors. Canada and Mexico represent very small markets for Colombian products.

A clear appraisal of existing barriers to trade should be the starting point of any evaluation of regional economic liberalization. The CGE model simulations later illustrated

are in fact based on the removal of ad valorem-equivalent price distortions against imports. These distortions originate in tariffs but also on a wide variety of other import restraints.

Table 2 [14] reports this distortion separately for Non Tariff Barriers (NTBs) and Tariffs. NTBs include real and implicit (contingent) quantity constraints, content requirements, rules of origin, and supervisory measures such as registration and inspection requirements. This table shows that North American tariff protection is relative low, but when NTBs are taken into account import distortions increase significantly. In the current version of the model, due to data limitation, NAFTA NTBs against Colombian products are set equal to those against the Rest of the World.[15] The last column shows Colombian tariff structure derived from the base year SAM tariff collection rates. The economy-wide average is relatively low, although some dispersion is shown in the rates. However, we should not expect dramatic structural adjustment effects from the simple removal of this remaining protection.[16]

IV. Simulations and results

This Chapter presents detailed interpretation for two of the many simulation experiments conducted with the NAFTA+ model described in the previous Chapter. The policy scenarios presented here contrast two cases, original NAFTA implementation (the full results of which can still only be estimated), and a four-country liberalization. In both cases, the removal of nominal protection as well as NTB-induced price distortions are considered. In both liberalisations, each trading partner maintains its existing protection with respect to the rest of the world.[17] Our results indicate that all four countries could realize gains from more liberal trade relations, and that each economy would undergo significant shifts in its trade and domestic resource use patterns. The differences between NAFTA and NAFTA+, however, are most significant for the new entrant, Colombia, indicating that all four economies have prior trade patterns, which are complementary and minimize diversionary effects, which would reduce incumbent advantages. The results are presented in three stages, beginning with a description of the experiments, followed by discussion of the aggregate results for several experiments and ending with a detailed sectoral discussion of the Colombian results.

NAFTA and Incremental NAFTA+ Effects: An Overview

An empirical simulation model with this level of detail can generate quantities of results that defy detailed exposition. This section provides only an overview of the aggregate and main qualitative effects of Colombian accession to NAFTA. This first set of results contrasts three-country NAFTA liberalization estimates with the incremental effects of Colombia accession to the group.[18] The basic NAFTA scenario is described elsewhere, the reader is referred there for details (see e.g. Reinert and Roland-Holst:1995b). Suffice to say for the moment that it simulates a very liberal base NAFTA convention, one that entails removal of all three-country bilateral tariff and non-tariff barriers observed in the base year. The second experiment, NAFTA+ or the inclusion of Colombian accession, is the same except that it includes Colombia's removal of existing tariff.[19]

Table 3 presents the basic NAFTA results, which again have been presented elsewhere and will not be discussed in detail here. Beyond the member countries in Experiment 1, note that Colombia actually benefits from the formation of NAFTA even when it is excluded. This result is hardly surprising, given the magnitude of income effects among its three trading partners, but it may provide comfort for other neighbours who choose to remain outside of regional agreements, i.e. trade creation might generally be

expected to outweigh trade diversion. Although Colombia experiences a small export decline when NAFTA is formed, the access to cheaper imported intermediates appears to slightly stimulate domestic employment from which modest welfare benefits are derived. The NAFTA results for Colombia are very small in any case, and one should be careful about generalising them.

The two most salient features of the NAFTA+ aggregate results are the significant gains for Colombia from accession and the negligible but positive difference it implies for the incumbents, and both results are intuitive. Colombia has a strong outward orientation and stands to gain appreciably from greater North American market access. It should be stressed that Colombian gains derive from this increased market access, given that its initial protection against North American imports is rather low. The Colombian absolute and relative magnitudes of the gains are smaller than those of its three trading partners because of its smaller economy and North American trade shares. Canada and Mexico have higher levels of trade dependency than the other two, and thereby enjoy greater relative stimulus from liberalization.

Like the U.S., Colombia experiences real exchange rate appreciation. This is a direct consequence of the closure of the external markets: with fixed trade balances a larger growth of imports than exports has to be balanced with a real exchange rate appreciation. Although Colombian resources are more efficiently allocated after liberalization, and thereby more exportables can be produced with the same resources, in order to pay for more imports and balance the trade account some appreciation is caused. Another way to see this adjustment process is the following. After reducing protection, NAFTA importers face cheaper prices for Colombian products (much cheaper for some of them, see Table 2). Therefore they increase their demands and this creates incentives to produce more exportables within Colombia. Production conditions here depend on substitution of inefficient domestic production with imports and on the supply constraints on primary factors. If factors are fixed, as in the current specification with a fixed capital stock and a positively sloped labour supply, only a limited expansion is possible before domestic resource cost goes up. Given that the real exchange rate basically represents this domestic resource cost, its appreciation is a direct consequence of NAFTA demand pressure on Colombian resources.

Judging from these results, the benefits of NAFTA incumbency are robust against this new entrant, although this conclusion might not generalize to economies which are more structurally similar to the incumbents (particularly Mexico). Apparently, Colombian export and import patterns with respect to the region are complementary with intra-regional bilateral trade, so relatively little net diversion occurs with Colombian accession.

Detailed Results

In this section, the effects of NAFTA accession on Colombia are discussed in greater detail. From these adjustments, lessons can be drawn for aspirant members of such a regional agreement. Table 4 presents the four main sectoral components of supply and demand for NAFTA+, measured as changes in percentage and base real value terms.

A striking feature of this table is that it records changes, which are much larger than those of Table 3. This is a quite common characteristic of these models. This also indicates why trade reforms' costs can be quite high for policy makers: losers are usually more organised and can easily coalesce and block a reform. The general pattern of structural adjustment that emerges is logical enough, stimulus to primary and textiles exports and imports of capital goods and chemicals. Both trends are consistent with an intensification of prior trade patterns for Colombia, particularly with respect to the US. The rise in imports

is more monotone across sectors, largely because of net income gains and real exchange rate appreciation.

Export adjustments, on the other hand, are slightly more variegated. They are fully consistent with a neoclassical model and with Ricardo's theory of comparative advantage. The Colombia economy as seen from the NAFTA (and US especially) is mainly a supplier of raw materials: coffee and oil. The booming sectors are in fact *Agriculture*, *Mining* and *Textiles*. These sectors continue to be an engine of foreign exchange generation, and this is likely to continue well into the future on current domestic and regional trends, only accelerating with the advent of North American trade preferences.

We also see a kind of "Dutch disease" at work, where the rising value of export earnings induces resource flows out of non-tradable sectors like services. To clarify this point, consider the first column in Table 4 and the Colombian economic and trade structure in Table 1 In this latter table, oil (that accounts for almost all the sector *Mining*) represents 8 per cent of gross production and 32 per cent of all exports with 47 per cent going to the US market. When barriers are removed, US demand for Colombia mining booms. Table 1 also shows that this sector is among the most capital intensive of Colombia. In order to expand *Mining* requires more capital and, given that this is fixed, the only source of capital is that released by the contracting sectors (non-tradable sectors as services and other relatively capital intensive sectors as paper, chemicals and non metal products). This may not be sufficient and thus the price of capital goes up causing the real exchange rate appreciation. The real exchange rate appreciation also damages other exports: Colombia finds itself in a sort of "Dutch disease" situation.

Table 5 presents the NAFTA+ agreement effects on trade flows. Import variations (as percentage change with respect to the base year) are shown along the rows, whereas export differences can be read along the columns. The left panel of Table 5 displays these effects on total exports and imports, the two other panels illustrate the special cases of *Mining* and *Textiles*. One feature emerges clearly: trade within the region registers a large increase. Yet some expansion is also recorded for the flows with the rest of the world signalling that trade creation does indeed prevail trade diversion. The only exception seems to be for Colombia on the import side. Notice that both Colombia and Mexico strongly expand their bilateral mining flows as well as their exports to the US. In fact some competition for the US market can arise among these two Latin American suppliers. In Colombia *Textiles*, a more mature and integrated industry, does not register any trade diversion due to further liberalisation.

Overall, the expansionary effects of NAFTA+ are concentrated in Colombia's primary sectors. One hopes that this can be augmented by shifting industry and investment policy emphasis toward higher average education levels and by the endogenous growth externalities of accelerating technology imports.[20] Simply put, NAFTA accession confers upon Colombia an intensification of its traditional patterns of comparative advantage, and these are unlikely to lead the country to the highest, most sustainable growth trajectories without co-ordination with policies which foster greater human capital development and broad-based economic modernization. This is a lesson that is probably of relevance to a large group of NAFTA aspirants.

V. Conclusion and Extensions

The more articulated trade linkages embodied in the NAFTA agreement are now a fact of life. Implementation of the agreement, however, is still in progress, and its ultimate effects on the member and other economies in the region will take years to be fully discernible. Meanwhile, empirical studies such as the present one can elucidate the

basic forces at work and provide a basis for analyzing other North-South trade liberalization initiatives. Many economy-wide evaluations of North American trade liberalization have been undertaken, but this one seeks to embark on an appraisal of the larger implications of Latin American regionalism. Using Colombia's NAFTA accession as a starting point, we attempted to assess the effects of a NAFTA+ arrangement for both the incumbents and the new entrant.

With a CGE model calibrated to a detailed four-country SAM, results were obtained which indicate that the North American trade relations are relatively robust to new membership in the trade compact by a more distant and structurally complementary economy like Colombia. While Colombia appears to enjoy substantial benefits from NAFTA+, most of the gains for the members of the original agreement are retained, and when they change it is usually for the better. In other words, Colombian accession appears to be more expansionary than contractionary for the North American incumbents.

The silver cloud of Colombian gains may have a somewhat tarnished lining, however, in the sense that accession appears primarily to intensify this country's traditional patterns of comparative advantage. This is typical of passive outward orientation, but Colombia has already demonstrated an understanding of this dilemma in its recent reformist experiments. It is still worth emphasizing, however, that opening markets alone is unlikely to get the country on the highest sustainable growth trajectories. These external reforms must be co-ordinated with domestic policies of human capital formation and investment, which foster growth and modernization externalities. Such policies can best be formulated on the basis of more detailed empirical work of this kind. In particular, a fully dynamic model taking into account investment as well as education decisions and policies would be the appropriate instrument of analysis, its construction and use is left for future research.

Notes

[1] *Note from the Steering Committee*: The continuity of the preparatory stage of the Free Trade Area of the Americas (FTAA) had its turning point in the framework of the Second Summit of the Americas where the Heads of State and Government from the 34 countries of the Hemisphere decided to formalize the launching of the negotiations which became effective as of September 1998.

[2] For a not too recent but still brilliant survey see Shoven and Whalley [1984].

[3] For examples see Flores [1997], Hinojosa-Ojeda, Lewis, and Robinson. [1995, 1997a and b], and Harrison, Rutherford, and Tarr [1997].

[4] See for instance the World Bank [1993] study on the East Asian Miracle.

[5] It should be noticed that some Non-Tariff Barriers (NTBs) still exist, and that recently new ones have been introduced.

[6] The main mandate of this new ministry was to foster Colombian integration in the region and in the international environment. The Institute of External Trade was transformed from the institute that was issuing import licensing into a forum to discuss and correct unfair trade practices. Other transformations aiming at stimulating exports and diffusing information affected the Banco de Comercio Exterior; additionally, Proexport Colombia and the Puntos de Informacion Comercial were instituted.

[7] Clearly in order to assess all potential trade policy alternatives for Colombia, one should construct a model, which includes all Colombian trading partners. However, for the reasons explained in the text, here we limit our analysis to the northern partners.

[8] See e.g. Reinert and Roland-Holst [1995] and Reinert, Roland-Holst, and Shiells [1993 1994a and 1994b].

[9] For an introduction to this type of trade specification, see de Melo and Robinson [1989]. The presence of intraindustry trade can modify results of simple interindustry models such as Stoper-Samuelson effects. See Reinert and Roland-Holst [1995] for an example.

[10] ROW import supply and export demand elasticities have been estimated by the authors for the United States, and in every case, for the present sectoral aggregation and magnitude of trade adjustments, the small country assumption appears to be tenable. We extended this reasoning to Canada, Mexico, and Colombia and thus the ROW price systems are essentially exogenous.

[11] See for instance Arango, Hernandez, Gracia and Ramirez [1997]. The detailed parametric information is available upon request from the authors.

[12] The new Colombian SAM, much more detailed than the NAFTA+ database, is described in greater detail in Bussolo, Correa and Prada [forthcoming].

[13] The same data is available on Mexico and Canada upon request.

[14] This table is derived from Reinert, Roland-Holst, and Shiells [1994b], Colombian data are added from official sources.

[15] For a few sectors (such as Mining) exception to this preliminary estimate is introduced.

[16] Some NTBs are adopted in Colombia and will soon be introduced in the analysis.

[17] It is possible that harmonization of ROW protection would alter the results given here, but such policies are not presently under consideration.

[18] For convenience, we assume that the latter event happens simultaneously with original NAFTA formation, thereby avoiding issues of sequencing and timing which are in any case not appropriate to this comparative static model.

[19] Currently the model does not include any NTBs for Colombia due to limitations in the data.

[20] See Collado, Roland-Holst, and van der Mensbrugghe [1995] for a discussion of these human capital issues in a regional context.

[21] See e.g. Katz and Summers [1989].

[22] This is equivalent to lump sum taxation or rebates.

Annex I

Specification of the NAFTA + Colombia CGE Model

For all the experiments reported above, a four-country Computable General Equilibrium (CGE) model was used. This Annex provides a more complete description of the model, whose main characteristics were introduced in Chapter 3.

The NAFTA + Colombia model is a four-country calibrated general equilibrium (CGE) model where domestic supply, demand, and bilateral trade for the United States, Canada, Mexico, and Colombia are fully endogenous. The second essential dimension of the model is the commodity (or sectoral) breakdown of economic activities. This version incorporates 19 sectors. The purpose of the commodity decomposition is to capture the essential features of NAFTA and Colombia structural adjustment in terms of domestic output, demand, factor use, and trade flows.

Production

As with many applied general equilibrium models, the NAFTA + Colombia model decomposes the production structure into a series of nested decisions allowing for a wide range of substitution possibilities between the various inputs. Figure 8 provides a graphical depiction of the nested production structure.

The top level of the production structure decomposes the production decision between aggregate inputs and an aggregate bundle composed of capital and labor value added. While there is the possibility for allowing some substitution between intermediate inputs and value added, for the purposes of this paper, it is assumed that the substitution elasticity is zero, or in other words the value added is always mixed in fixed proportions with intermediate inputs. It is also assumed that all the intermediate inputs are consumed in fixed proportion amongst themselves, though it is possible to substitute between domestic and imported intermediate goods.

The next level of the production structure decomposes the value-added bundle into aggregate labor demand, on the one hand, and a capital on the other.

Consumption

For each household, there is a single representative consumer who allocates disposable income across the various commodities. The model uses an extension of the familiar Stone-Geary consumer demand system, known as the extended linear expenditure system (ELES). The ELES has several distinct advantages over other demand systems. It allows for commodity-specific income elasticities, which can either be econometrically estimated or derived from literature searches, it is easy to calibrate and implement, and it integrates the household saving decision in the consumer optimization process. In the ELES system, consumption is represented as the sum of two components, a subsistence minimum, and a share of supernumerary income, which is the residual disposable income after subtracting expenditures on the subsistence minimum. Households direct taxation is a fixed proportion of income.

Other Final Demand

There are three other domestic final demand accounts: government expenditures, investment expenditures, and changes in inventory. Aggregate real government expenditure is assumed to be fixed, while aggregate real investment

expenditure will depend upon the closure rule. The decomposition into demand for commodities is assumed to use fixed shares in both cases.

Trade

The model uses an extension of the familiar Armington hypothesis to implement trade equations. The principle behind the Armington assumption is that goods are differentiated according to region of origin. In practice this means that each agent specifies demand for a specific *aggregate* good (derived from maximizing utility for example). This good is a constant elasticity of substitution (CES) aggregate of imports and domestic products in each sector. At this stage of the demand system, agents decompose demand for the aggregate good into its domestic and (aggregate) import components based on relative prices and (calibrated) penetration shares.

Export supply is treated symmetrically to import demand, i.e. domestic producers are assumed to differentiate between domestic and export markets. A rise in export prices (relative to domestic prices), induces producers to shift production resources towards export markets. The model implements a constant elasticity of transformation (CET) curve to capture this assumption.

Equilibrium

Production is modeled with a constant-returns-to-scale technology, which guarantees that supply equals domestic plus external (export) demand for domestic output. Factor prices, wages and capital returns, are generally determined by equilibrium conditions. In both markets there are a wide range of possibilities. We assume that aggregate capital is fixed in supply and mobile between sectors. We assume that labor is perfectly mobile across sectors, which implies a single economy-wide average wage rate, assuming labor markets are competitive. A number of authors have demonstrated, however, that significant and persistent wage differentials exist across sectors for the same occupational groups.[21] To account for this, we calibrate a distribution of inter-sectoral wage differentials, which are held constant during the simulations.

Closure

There are three key macro closure rules. The first concerns the government revenue-expenditure balance. For the purposes of the simulations, we assume real government saving is fixed in each region. The instrument used to achieve the balance is the household tax schedule, which will shift either right or left to guarantee the budget balance holds.[22]

The second closure rule concerns the saving-investment balance. Domestic investment is determined by the stock of domestic private and public saving, plus net foreign saving (which is exogenous).

The third and final closure rule governs the external account, where we assume that the trade balance is equal to the level of foreign saving. With fixed foreign saving, all adjustment is necessarily mediated by the real exchange rate, since increased import demands which follow from trade liberalization must be financed by increased exports. At rigid terms-of-trade, exports can only expand by attracting resources whose relative prices have declined due to structural adjustment in other sectors. These include tradeables, which are being displaced by new imports, and non-tradeables, whose price declines both contribute to falling domestic resource costs or real exchange rate depreciation.

I. SETS AND INDICES

Sets

I	{1,…19}	Sectors
J	{Canada (C), Mexico (M), United States (U), Colombia (CO)}	FTA countries
K	{C,M,U,CO, Rest of the World (R)}	World countries

Indices

$h,i \in I$
$j \in J$
$k \in K$

II. STRUCTURAL EQUATIONS

Consumer Behavior

$$P_{ij}^{Q} C_{ij} = P_{ij}^{Q} \mu_{ij} + s_{ij} \left(Y_j - \sum_{j=1}^{n} P_{ij}^{Q} \mu_{ij} \right) \qquad \forall i,j \tag{2.1}$$

Production technology

$$F_{ij} = \left(r_j KF_{ij} + w_j LF_{ij} \right) \left(n_{ij} / n0_{ij} \right) \qquad \forall i,j \tag{2.2}$$

$$V_{ij} = \left(X_{ij} / a_{ij} \right) \left[b_{ij}^{\Phi_{ij}} w_j^{\left(1-\Phi_{ij}\right)} + \left(1 - b_{ij}^{\Phi_{ij}}\right) r_j^{\left(1-\Phi_{ij}\right)} \right]^{1/\left(1-\Phi_{ij}\right)} \qquad \forall i,j \tag{2.3}$$

$$T_{ij} = F_{ij} + V_{ij} + \sum P_{hj}^{Q} \, io_{ij} \, X_{ij} \qquad \forall i,j \tag{2.4}$$

Factor Demands

$$L_{ij} = V_{ij}^{\Phi_{ij}} X_{ij}^{\left(1-\Phi_{ij}\right)} b_{ij}^{\Phi_{ij}} w_j^{-\Phi_{ij}} a_{ij}^{\left(\Phi_{ij}-1\right)} \qquad \forall i,j \tag{2.5}$$

$$K_{ij} = V_{ij}^{\Phi_{ij}} X_{ij}^{\left(1-\Phi_{ij}\right)} \left(1 - b_{ij}^{\Phi_{ij}}\right) r_j^{-\Phi_{ij}} a_{ij}^{\left(\Phi_{ij}-1\right)} \qquad \forall i,j \tag{2.6}$$

Factor Markets

$$\sum_i K_{ij} + \sum_i KF_{ij}\left(n_{ij}/n0_{ij}\right) = K_j \qquad \forall j \tag{2.7}$$

$$w_j = w0_j \qquad \forall j \tag{2.8}$$

Commodity Demands, Supplies, and Allocation of Traded Goods

$$Q_{ij} = \alpha_{ij}\left[\sum_k \beta_{ijk}\, D_{ijk}^{\left(\sigma_{ij}-1\right)/\sigma_{ij}}\right]^{\left(\sigma_{ij}-1\right)/\sigma_{ij}} \qquad \forall i,j \tag{2.9}$$

$$\left(D_{ijk}/D_{ijj}\right) = \left[\left(\beta_{ijk}/\beta_{ijj}\right)\left(P_{ijj}^{D}/P_{ijk}^{D}\right)\right]^{\sigma_{ij}} \qquad \forall i,j,k \tag{2.10}$$

$$X_{ij} = \gamma_{ij}\left[\sum_k \delta_{ijk}\, S_{ijk}^{\left(\tau_{ij}-1\right)/\tau_{ij}}\right]^{\left(\tau_{ij}-1\right)/\tau_{ij}} \qquad \forall i,j \tag{2.11}$$

$$\left(S_{ijk}/S_{ijj}\right) = \left[\left(\delta_{ijk}/\delta_{ijj}\right)\left(P_{ijj}^{S}/P_{ijk}^{S}\right)\right]^{\tau_{ij}} \qquad \forall i,j,k \tag{2.12}$$

Commodity Prices

$$P_{ij}^{Q}\, Q_{ij} = \sum_k P_{ijk}^{D}\, D_{ijk} \qquad \forall i,j \tag{2.13}$$

$$P_{ij}^{X}\, X_{ij} = \sum_k P_{ijk}^{S}\, S_{ijk} \qquad \forall i,j \tag{2.14}$$

$$P_{ijk}^{D} = \left(1 + t_{ijk}\right)\left(1 + \rho_{ijk}\right) er_j\, PW_{ijk}^{D} \qquad \forall i,j,k \tag{2.15}$$

$$P_{ijk}^{S} = er_j\, PW_{ijk}^{S} \qquad \forall i,j,k \tag{2.16}$$

$$PW_{ijk}^{D} = er_j\, PW_{ijk}^{S} \qquad \forall i,j,k \tag{2.17}$$

$$P_{ijj}^{D} = P_{ijj}^{S} \qquad \forall i,j \tag{2.18}$$

$$PW_{ijR}^{D} = PW0_{ijR}^{D} \qquad \forall i,j \tag{2.19}$$

$$PW_{ijR}^{S} = PW0_{ijR}^{S} \qquad \forall i,j \tag{2.20}$$

Commodity Market Equilibrium

$$Q_{ij} = C_{ij} \sum_{h} io_{i\,j}\, X_{j} \qquad \forall i,j \tag{2.21}$$

$$D_{ijk} = S_{ikj} \qquad \forall i,j,k \tag{2.22}$$

Income and Government Revenue

$$YL_{j} = w_{j} \sum_{i} \left[LF_{ij} \left(n_{ij} / n0_{ij} \right) + L_{ij} \right] \qquad \forall j \tag{2.23}$$

$$YK_{j} = r_{j} \sum_{i} \left[KF_{ij} \left(n_{ij} / n0_{ij} \right) + K_{ij} \right] \qquad \forall j \tag{2.24}$$

$$RT_{j} = \sum_{i} \sum_{i} t_{ijk}\, er_{j}\, PW_{ijk}^{D}\, D_{ijk} \qquad \forall j \tag{2.25}$$

$$RQ_{j} = \sum_{i} \sum_{k} \rho_{ijk} \left(1 + t_{ijk} \right) er_{j}\, PW_{ijk}^{D}\, D_{ijk} \qquad \forall j \tag{2.26}$$

$$Y_{j} = YL_{j} + YK_{j} + RT_{j} + RQ_{j} + \sum_{i} \pi_{ij} \qquad \forall j \tag{2.27}$$

Perfectly Competitive Behavior

$$P_{ijj}^{D} = \left(V_{ij} + \sum_{i} P_{hj}^{Q}\, io_{hij}\, X_{ij} \right) \Big/ X_{ij} \qquad \forall i,j \tag{2.28}$$

Balance of Payments

$$\sum_{k \neq j} \sum_{i} \left(PW_{ijk}^{S}\, S_{ijk} - PW_{ijk}^{D}\, D_{ijk} \right) = 0 \qquad \forall j \tag{2.29}$$

III. Variable and Parameter Definitions

Price Variables

er_j	Exchange rate in country j
P^D_{ijk}	Domestic purchaser price of good i in country j demanded from country k
P^Q_{ij}	Domestic purchaser price of composite consumption good i in country j
P^S_{ijk}	Domestic producer price of good i in country j supplied to destination country k
P^X_{ij}	Domestic producer price of composite production good i in country j
PW^D_{ijk}	World price of good i in country j demanded from source country k
PW^S_{ijk}	World price of good i in country j supplied to destination country k
r_j	Rental rate on capital in country j
w_j	Wage rate in country j

Quantity variables

C_{ij}	Final demand for composite consumption good i in country j
D_{ijk}	Demand for good i in country j from source country k
K_{ij}	Variable capital used in sector i of country j
L_{ij}	Variable labor used in sector i of country j
n_{ij}	Number of firms in sector i of country j
Q_{ij}	Final plus intermediate demand for composite consumption good i in country j
S_{ijk}	Supply of good i from country j to destination country k
X_{ij}	Gross Domestic output of sector i of country j

Nominal variables

F_{ij}	Fixed costs in sector i of country j
RQ_j	Quota rents in country j
RT_j	Tariff revenues in country j
T_{ij}	Total costs in sector i of country j
V_{ij}	Variable costs in sector i of country j
Y_j	Income in country j
YL_j	Labor Income in country j
YK_j	Capital Income in country j
π_{ij}	Profits in sector i of country j

Structural and Policy Parameters

a_{ij}	Intercept parameter in CES production function in sector i of country j
b_{ij}	Share parameter in CES production function in sector i of country j
io_{hij}	Input of sector h needed per unit of sector i output in country j
K_j	Total capital stock in country j
KF_{ij}	Fixed capital in sector i of country j
LF_{ij}	Fixed labor in sector i of country j

$n0_{ij}$ Number of firms in benchmark equilibrium in sector i of country j

$PW0^{D}_{ijR}$ World price of good i in country j demanded from the rest of the world in the benchmark equilibrium

$PW0^{S}_{ijR}$ World price of good i in country j supplied to the rest of the world in the benchmark equilibrium

s_{ij} Consumption share for composite good i in country j

t_{ijk} Ad valorem tariff on imports of good i into country j from country k

$w0_{j}$ Wage rate in country j in benchmark equilibrium

α_{ij} Intercept parameter in CES product aggregation function in sector i of country j

β_{ijk} Share parameter in CES product aggregation function in sector i of country j from country k

δ_{ijk} Share parameter in CET allocation function from sector i in country j to destination country k

γ_{ij} Intercept parameter in CET allocation function for sector i in country j

μ_{ij} Subsistence minimum for composite consuption good i in country j

Φ_{ij} Elasticity of substitution between variable capital and variable labor in sector i production in country j

ρ_{ijk} Ad valorem equivalent quota on imports of good i into country j from country k

σ_{ij} Elasticity of substitution among sources of product i in country j

τ_{ij} Elasticity of transformation among destinations for product i of country j

Annex II

Figures and Tables

Figure 1

Imports by Region (%)

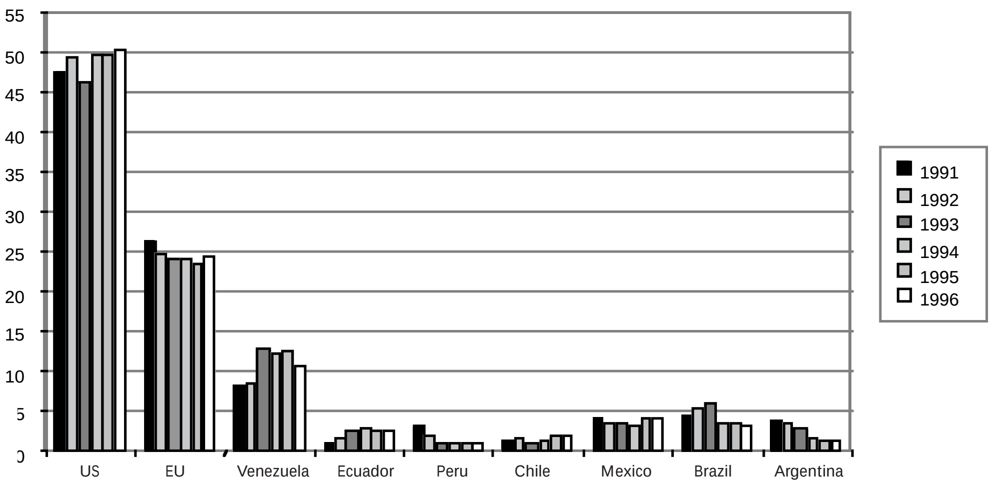

Figure 2

Exports by region (%)

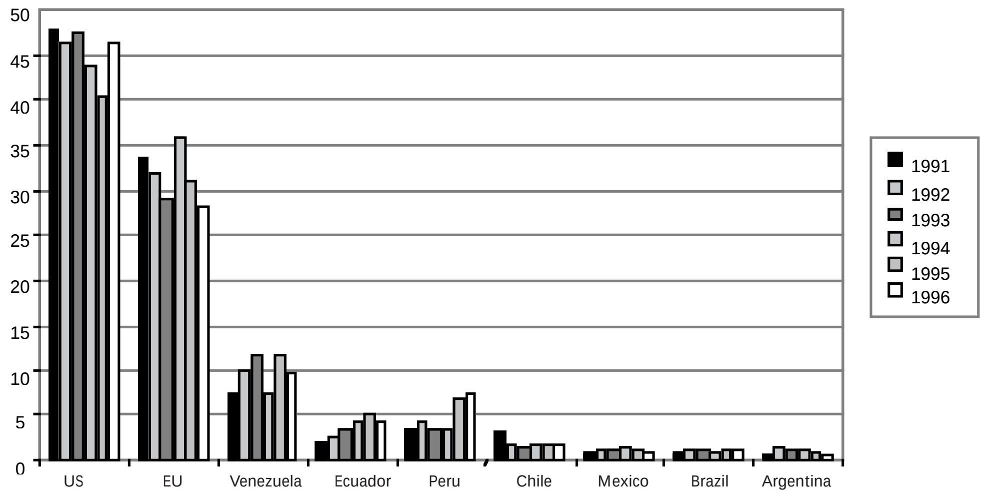

Figure 3

AVERAGE YEARLY GROWTH RATES (%)

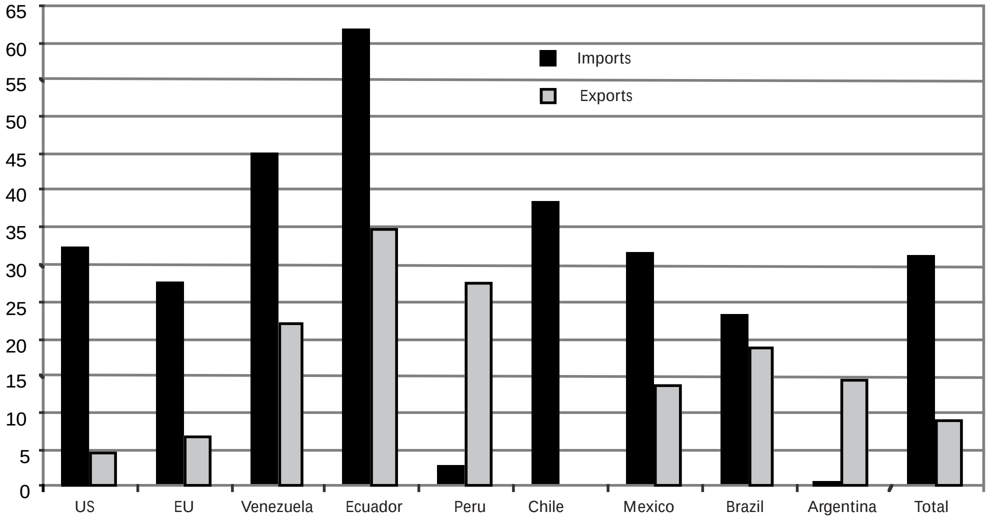

Figure 4

EXPORTS TO THE U.S. (%)

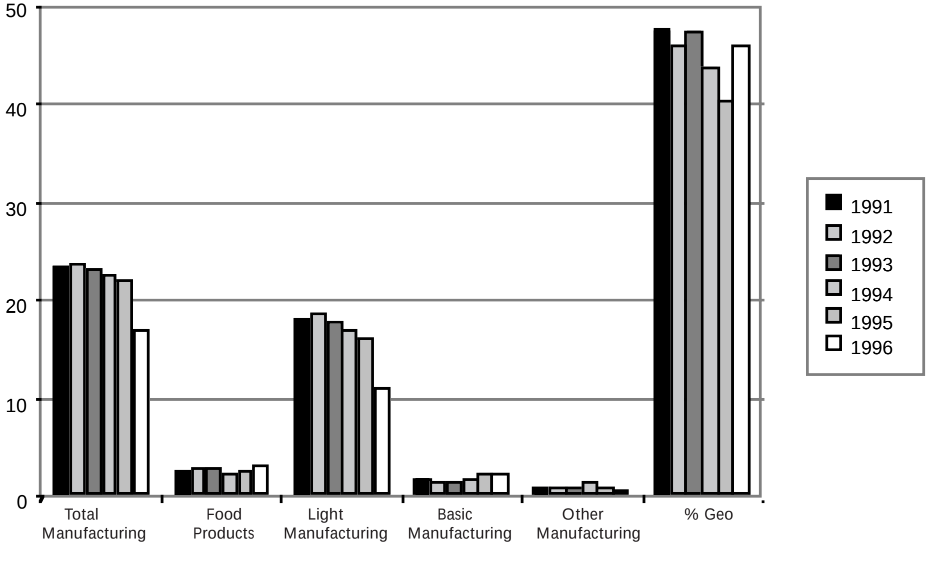

Figure 5

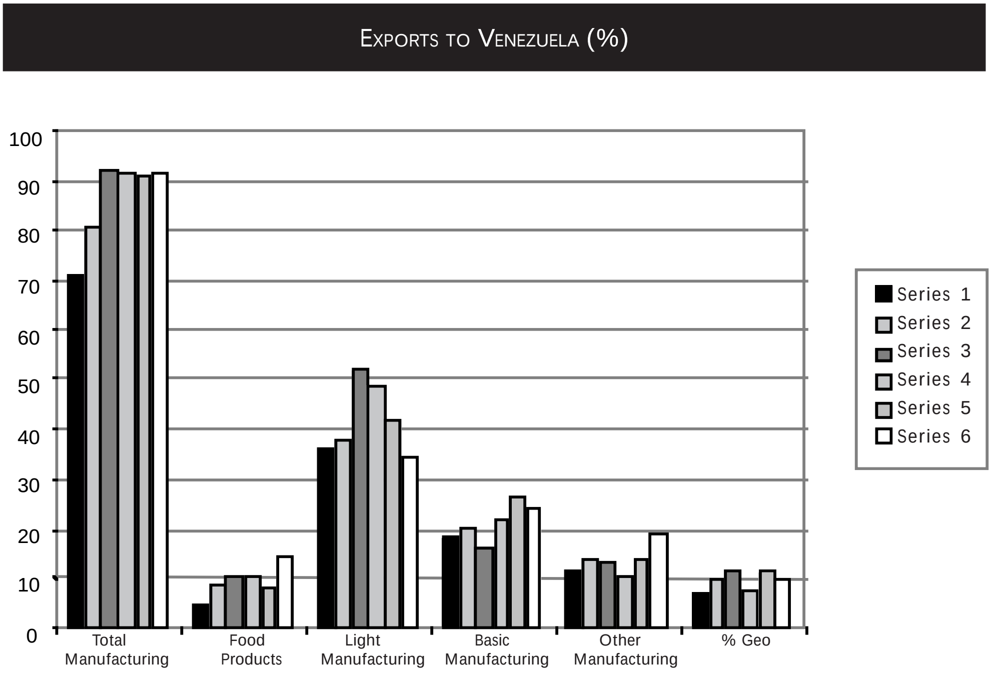

Figure 6

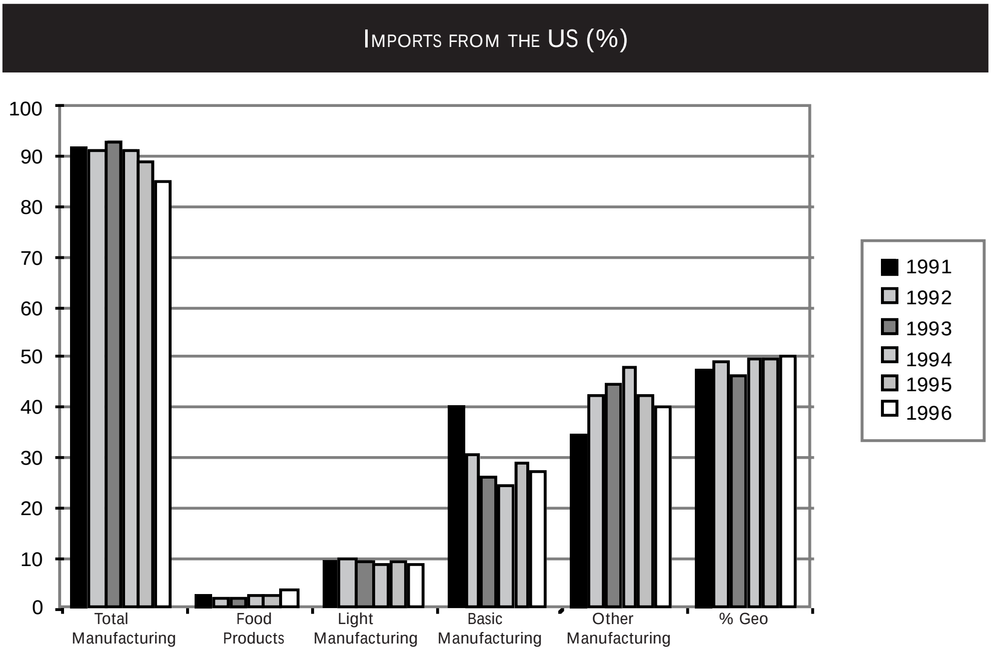

Figure 7

IMPORTS FROM VENEZUELA (%)

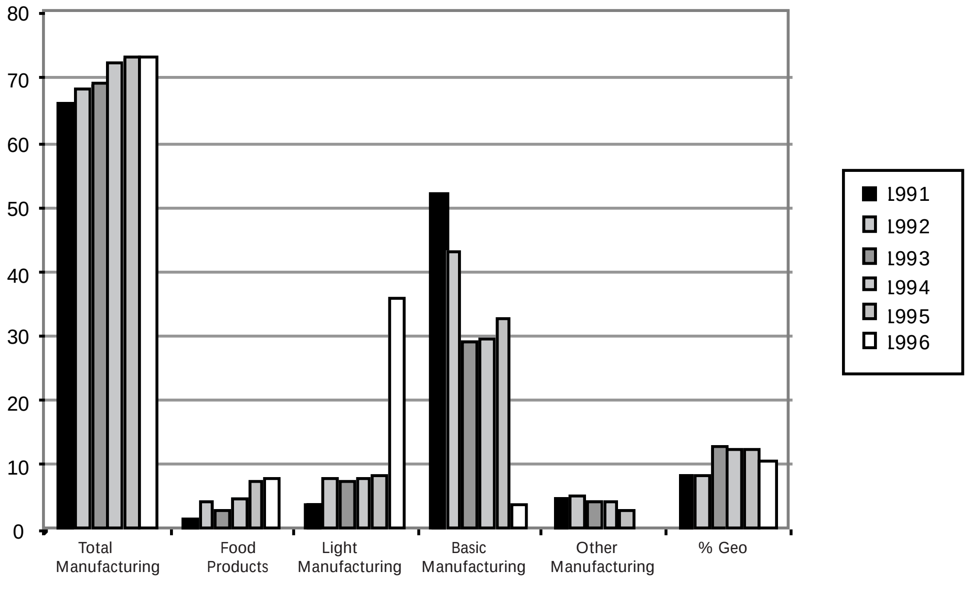

Figure 8

PRODUCTION STRUCTURE

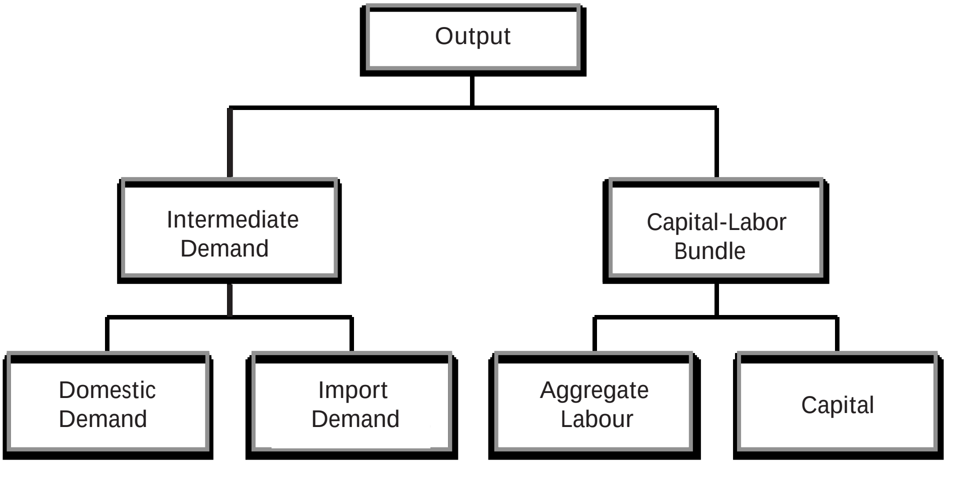

Table 1

US AND COLOMBIA ECONOMIC STRUCTURE (% OF BASE YEAR SAM)

		Gross Product		Imports		Exports		VI / Vk		Colombian exports to:			
		USA	Col.	USA	Col.	USA	Col.	USA	Col.	Can.	USA	Mex	ROW
1	Agriculture	2	12	2	5	5	11	24	74	2	36	0	63
2	Mining	3	8	10	7	3	32	46	21	0	47	0	53
	Primary	5	20	12	13	7	43	35	53	0	44	0	55
3	Food Products	3	12	3	3	4	20	139	41	0	3	0	97
4	Beverage	1	2	1	0	0	0	83	171	0	69	0	31
5	Tobacco	0	0	0	0	1	0	41	226	0	36	0	64
6	Textiles	2	4	8	6	2	11	576	131	1	47	1	51
7	Paper	2	2	2	3	3	2	193	53	0	22	12	67
8	Chem/rub	4	7	6	20	10	6	153	82	0	7	3	89
9	Non metal	1	2	1	1	1	1	314	73	2	11	2	84
10	Metal.wood prod.	4	3	8	10	6	2	1,620	142	0	20	3	76
11	N.e. equipment	4	1	23	21	23	2	597	160	0	12	4	84
12	Trns. equipment	4	1	15	10	15	1	370	396	0	16	1	82
13	Other manufactures	2	1	6	2	4	1	186	99	0	16	1	82
	Manufactures	27	34	72	78	69	46	301	84	1	17	2	81
14	Construction	6	5	0	0	0	0	290	59	0	0	0	0
15	Electricity	3	2	1	0	0	0	54	46	0	0	0	0
16	Commerce	13	7	3	0	5	1	275	32	0	30	1	68
17	Trns. Com.	5	9	11	7	14	9	245	71	0	30	1	68
18	Fin.insurance	14	7	1	1	3	1	37	61	0	30	1	68
19	Other services	26	16	1	0	2	0	378	243	0	0	0	0
	Services	68	46	16	9	23	11	184	92	0	30	1	68
	Total	100	100	100	100	100	100	189	80	0	30	1	68

Table 2

NAFTA and Colombia Trade Protection Rates

		NTBS ad Valoem estimates												Tariffs												
		USA NTBs against:				Can NTBs against:				Mex NTBs against				USA Tariffs against:				Can tariffs against:				Mex. Tariffs against:				
		USA	Can.	Mex.	Row	USA	Can.	Mex.	Row	USA	Can.	Mex.	Row	USA	Can.	Mex.	Row	USA	Can.	Mex.	Row	USA	Can.	Mex.	Row	Col.
1	Agriculture		12	43	23	82		97	80	83	100		80		1	4	0	0		1	2	6	6		6	11
2	Mining		66	96	90	47		7	26	84	0		26		0	0	1	0		0	0	4	5		4	9
3	Food Products		21	22	23	54		73	54	98	80		54		2	9	3	0		3	7	7	7		7	11
4	Beverage		94	93	94	0		0	0	100	0		0		1	3	2	0		30	37	11	11		11	6
5	Tobacco		81	23	11	0		0	0	100	0		0		6	6	8	0		20	30	8	8		11	3
6	Textiles		0	50	41	52		90	55	3	0		55		7	11	13	0		13	15	8	4		8	6
7	Paper		0	0	0	0		0	1	64	84		1		0	3	1	0		3	11	4	6		4	4
8	Chem/rub		4	10	4	5		0	5	2	4		5		2	2	5	0		4	10	6	7		6	8
9	Non metal		0	57	3	9		3	14	3	0		14		1	3	6	0		4	10	7	7		7	10
10	Metal.wood prod.		17	27	30	26		51	30	45	0		30		1	2	3	0		4	9	8	7		7	7
11	N.e. equipment		3	1	9	1		0	1	14	15		1		1	4	3	0		2	4	7	7		7	5
12	Trns. equipment		65	4	68	57		76	61	17	0		61		0	2	2	1		1	4	7	9		7	15
13	Other manufactures		2	21	24	13		12	26	1	0		26		2	4	4	0		4	7	8	6		8	9
14	Construction		0	0	0	0		0	0	0	0		0		0	0	0	0		0	0	0	0		0	0
15	Electricity		0	0	0	0		0	0	0	0		0		0	0	0	0		0	0	0	0		0	0
16	Commerce		0	0	0	0		0	0	0	0		0		0	0	0	0		0	0	0	0		0	6
17	Trns. Com.		0	0	0	0		0	0	0	0		0		0	0	0	0		0	0	0	0		0	0
18	Fin.insurance		0	0	0	0		0	0	0	0		0		0	0	0	0		0	0	0	0		0	0
19	Other services		0	0	0	0		0	0	0	0		0		0	0	0	0		0	0	0	0		0	0
	Economy-wide		**41**	**28**	**32**	**31**		**30**	**33**	**22**	**36**		**30**		**1**	**3**	**3**	**2**		**4**	**4**	**2**	**2**		**2**	**11**

Table 3

AGGREGATE SIMULATION RESULTS												
	Experiment 1: NAFTA				Experiment 2: NAFTA+				Differences			
	USA	Can.	Mex.	Col.	USA	Can.	Mex.	Col.	USA	Can.	Mex.	Col.
Equivalent Variation Income (%)	1.34	4.73	1.78	0.08	1.36	4.74	1.78	0.91	0.02	0.01	0.01	0.83
Real GDP	1.03	6.10	3.06	0.00	1.05	6.11	3.07	0.07	0.02	0.01	0.01	0.07
Imports	7.93	17.43	13.38	0.33	8.00	17.46	13.41	6.44	0.07	0.03	0.04	6.11
Exports	5.99	24.74	23.10	-0.10	6.12	24.77	23.14	1.17	0.13	0.03	0.04	1.27
Real Exchange Rate	-0.35	-0.11	4.88	0.02	-0.30	-0.09	4.91	-5.74	0.05	0.02	0.03	-5.76
Employment (%)	1.25	5.79	3.25	0.03	1.28	5.80	3.26	0.31	0.03	0.01	0.01	0.28

Experiment 1: Bilateral Tariff and NTB Removal for the United States, Canada, and Mexico
Experiment 2: Bilateral Tariff and NTB Removal, all Four Countries

Table 4

Sectoral Adjustment for Colombia

		Percentage Changes w.r.t. base year				Changes in 1992 USD			
		Domestic Supply	Exports	Domestic Demand	Imports	Domestic Supply	Exports	Domestic Demand	Imports
1	Agriculture	-0.71	4.65	-0.41	18.37	-76	43	-42	77
2	Mining	1.25	3.27	0.43	4.54	87	92	20	26
3	Food Products	-1.34	-4.98	-0.37	7.07	-134	-85	-31	18
4	Beverage	0.02	10.26	0.04	4.46	1	1	1	1
5	Tobacco	0.27	1.46	0.16	3.57	1	0	0	0
6	Textiles	6.97	15.73	4.34	7.12	267	157	143	33
7	Paper	-0.57	-2.77	0.19	3.99	-12	-5	4	10
8	Chem/rub	-0.81	-5.89	0.78	5.16	-53	-31	59	81
9	Non metal	-0.22	-1.73	0.32	5.90	-3	-2	4	6
10	Metal.wood prod.	0.19	-1.58	1.37	4.55	5	-2	43	37
11	N.e. equipment	1.06	-2.42	3.08	5.01	23	-5	112	84
12	Trns. equipment	4.62	0.99	6.62	10.02	69	0	148	80
13	Other manufactures	1.69	-3.08	3.20	5.59	9	-2	21	10
14	Construction	0.42	0.00	0.42	0.00	18	0	18	0
15	Electricity	0.41	0.00	0.41	0.00	7	0	7	0
16	Commerce	0.50	-5.40	0.55	7.99	35	-3	38	1
17	Trns. Com.	-0.96	-6.24	0.08	5.76	-77	-51	7	32
18	Fin.insurance	-0.15	-6.01	0.03	5.80	-10	-6	2	6
19	Other services	-0.11	0.00	-0.10	5.73	-14	0	-14	1

Table 5

Trade effects: Multilateral Flows as Percentages of Base Year

	Total					Mining					Textiles				
	USA	Can.	Mex.	Col.	**Row**	USA	Can.	Mex.	Col.	**Row**	USA	Can.	Mex.	Col.	**Row**
USA	—	24	23	8	**2**	—	29	36	7	**1**	—	27	6	8	**2**
Can.	33	—	89	12	**9**	39	—	7	10	**13**	7	—	7	10	**6**
Mex.	29	42	—	11	**10**	76	31	—	23	**52**	35	56	—	12	**11**
Col.	23	54	12	—	**-9**	23	32	22	—	**-15**	31	54	6	—	**1**
Row	**2**	**10**	**0**	**5**	**—**	**-2**	**6**	**-1**	**4**	**—**	**1**	**4**	**-1**	**6**	**—**

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Contents

MERCOSUR: Why Does Monetary Union Make Sense in the Long-term?

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Summary

This paper adopts a broad approach to justify the long-term objective of monetary unification among MERCOSUR countries. The risks of dilution of this agreement within a probable much more extense free trade area, that is from Tierra del Fuego to Alaska (ALCA), are exposed. After drawing an analogy with European integration, the requirements for a single currency and the increasing homogeneity of the economies of the region are described and the debate "monetary unification vs. dollarization" is analyzed. The text ends with a proposition of an agenda for the 2000/2002 period. It is emphasized that, even not being an immediate goal, monetary unification tends to be the natural consequence of the advancements in the process of regional integration.

> *"Ultimately, a single market requires a single currency. A single market calls for a reference unit in which the value of the goods and services and financial contracts can be expressed. This unit does not exist in a single market with different currencies. To maintain national currencies entails the existence of different monetary policies with different inflation rates and the inherent risk of the variation in rate parities." (Collignon, Bofinger, Johnson and De Maigret, [1994] pp. 88)*
>
> *"The FTAA will not be anything that is not wanted and approved by the United States. MERCOSUR will be whatever its partners want it to be" (Roberto Lavagna).*

I. Introduction [1]

In an article on free trade written in May 1997, Barry Eichengreen, recognized as one of the most important authorities on global monetary issues, referred in passing to the idea of creating a single currency in MERCOSUR. In the article, he stated that: "This is unrealistic ... over any horizon relevant for policy planning" since, in contrast to the intensity of European integration, "<u>nothing similar is likely to occur in our lifetimes in South America</u>" (Eichengreen [1997] p. 31, emphasis added).

This is an initial reaction that is common to most observers when examining the idea of monetary union in MERCOSUR. However, if the question is analyzed in greater depth, the conclusions that emerge can differ greatly. In fact, even Eichengreen, in an

article written specifically on this issue one year later, and interestingly called "Does MERCOSUR Need a Single Currency?", expressed a markedly different opinion from that cited previously. In this new article, the author acknowledged that "there is a coherent political-economy logic for why the members of the customs union might contemplate a common currency" (Eichengreen [1998] p. 4) and, in referring to the countries of the sub-region, stated that "if they intend to press on to deeper integration, then they, like their European counterparts, will also have to contemplate monetary integration" (p. 10). Moreover, after asserting that "the option of monetary union cannot be ruled out as infeasible a priori" (p. 25), Eichengreen concluded in the article that, in contrast to the totally skeptical view expressed a year previously: "If [integration] ... develops a readiness to transform Mercosur into a more far-reaching integration initiative, involving the creation of a true single, integrated South American market, then exchange rate swings will become more politically disruptive, and monetary unification becomes <u>not only feasible but essential</u>" (p. 33, emphasis added).

How was this idea arrived at? In all processes of integration between countries of a sub-region there is a natural sequence that has to be followed. This begins with the establishment of a free trade area (FTA), followed by the introduction of a common external tariff (CET), and culminates in the creation of a common market. The latter is characterized by the constitution of a geographic area in which some countries, while preserving their own laws and political organization, harmonize their respective legislation in certain areas, coordinate their macroeconomic policies and, in general, allow the "four freedoms": the free circulation of goods, services, labor and capital. At a later stage, the common market could also include monetary union. Western Europe, or at least a large part of it, is soon to enter this "fourth stage" of integration – that is, the establishment of monetary union. This will take place after the physical substitution of the national currencies of the countries involved by the currency of the European Monetary Union (EMU) – then "euro" – in 2002.

The Treaty of Asunción, which gave rise to MERCOSUR, foresees a sequence of events similar to that discussed above, although there is no reference to monetary union. Article 1 of MERCOSUR's founding treaty thus states that "the member states agree to create a common market that … will be called the 'Southern Common Market (*Mercado Común del Sur*, MERCOSUR). This common market implies: the free circulation of goods, services, and productive factors between the countries …; the establishment of a common external tariff and the adoption of a common trade policy in relation to third countries …; macroeconomic and sectoral policy coordination between the member states, including foreign trade, agricultural, industrial, <u>fiscal, monetary, exchange rate, and capital</u> policy …"(emphasis added). However, despite the treaty being signed and the FTA and CET defined and initiated many years ago, although with some problems, little or no progress has been made in respect to the creation of a common market.[2]

This loss of dynamism in regional integration implies two types of problems for the future of MERCOSUR. First, "in a competitive and dynamic world where productive investment is in dispute, by not <u>advancing or advancing quickly the process is reversed</u>" (Lavagna [1996] p. 2, emphasis added).[3] Second, if MERCOSUR limits itself to an FTA with a CET, its strength will be significantly diminished when the Free Trade Area of the Americas (FTAA) is established. This is because, once tariffs disappear in the Americas, the ability of the sub-region to distinguish itself from the rest of the countries will naturally be undermined. In other words, *for MERCOSUR to conserve its strength once the FTAA is established, the former should be far more than a free trade area with a common external tariff*.

Taking these arguments into consideration, discussion of the possibility of establishing a single currency for the MERCOSUR countries, perhaps in the second decade of the twenty-first century, began in 1997. For this to occur, however, the countries would

have to begin preparations much in advance (Giambiagi [1997, 1998]; Lavagna and Giambiagi [1998]; Rigolon and Giambiagi [1999]). This idea was first raised in a press article published in the *Estado de São Paulo* on 8 April 1997 ("A Proposal for MERCOSUR"), which summarized a purely academic article by Giambiagi [1997]. This idea attained political momentum when it was included in MERCOSUR's diplomatic agenda after being mentioned by Argentine President Carlos Menem in a press interview on 27 April 1997. Menem made further references to the proposal on numerous occasions. The idea thus began to be identified as an Argentine proposal. The Argentine government even held an international seminar on the issue in Buenos Aires in June 1998.[4] At the same time, the MERCOSUR authorities began to discuss the issue, although informally, after it was mentioned in statements made by some Argentine authorities.[5] Examining this issue so much in advance may appear rather surrealist, but taking global geopolitical considerations into account, such anticipation is reasonable and forms part of the countries' strategic vision in this respect.[6]

In a certain way, this type of logic also influenced European integration *vis-à-vis* the creation of the euro. This was seen as an incentive for the EMU member states to make greater efforts to advance in areas where progress had been slow – such as in cooperation and mutual understanding – despite Europe's long history of integration. This was acknowledged by Jaques Delors, one of the mentors of monetary union: "In the longer run, <u>European Monetary Union should also promote the partial harmonization of national tax and labor policies</u>. In other words, the virtuous cycle now underway should lead, via a single currency, to still further economic integration" (Delors [1997] p. 17, emphasis added).

This study is divided into nine sections. After this introduction, prospects for MERCOSUR after the possible establishment of the FTAA are examined. Interpretations of the origins and logic guiding the European unification proposal, via the 1992 Maastricht Treaty – which influenced MERCOSUR's proposal for monetary union – will then be analyzed. Section four highlights the prerequisites that are generally viewed as fundamental for the creation of a monetary union. Section five examines recent trends towards greater macroeconomic convergence in the MERCOSUR countries. Section six examines developments since 1997, when the first informal discussions on the idea of monetary union began. This section is followed by a defense of this unification proposal, in the context of MERCOSUR, as a long term project for the sub-region. Section eight examines the dollarization proposal as an alternative to the above-mentioned proposal for unification. Finally, a working agenda for the 2000-2002 period is examined.

II. MERCOSUR and the Challenge of the FTAA

In the last few years, the unity of MERCOSUR has been undermined by events such as, for example, Argentina's opposition to Brazil's candidacy to a place on the UN Security Council; the criticism of prominent Brazilian political leaders of what they saw as closer ties between Argentina and the United States, to the detriment of its regional partners; the Argentine Congress's approval of a law preventing the application of preferential tariffs on Brazilian sugar imports to Argentina; the retaliatory measures of Brazilian political leaders, through an initiative by the President of MERCOSUR's Parliamentary Commission, consisting of a legislative decree bill that banned the import of Argentine wheat; etc. It is highly unlikely that these problems would have had the fertile ground to flourish had MERCOSUR been in a phase of continuous progress, as in the first half of the 1990s. *These issues suggest the existence of an "adolescent crisis" in MERCOSUR*, which should define what future it wants.

The succession of frictions and the increasing unwillingness to make any concessions towards integration highlight the need to discuss the future of MERCOSUR once an FTA and a CET are established among its member states. The fact that these

frictions occurred highlights the need to upgrade MERCOSUR in such a way that it ceases to be a mere trade agreement and, continuing to deepen integration, makes progress towards the creation of a truly common market.

To a certain extent, MERCOSUR is at a crossroads.[7] One possibility, alternative A, would be to view the progress made thus far as satisfactory and in which *no further progress should be made*. In this respect, alternative B would consist of making a *leap forward* and of identifying new areas of integration, with the underlying advantage of definitively consolidating trade integration.

Alternative A implies adopting a passive approach, although there are serious problems associated with it: *if MERCOSUR is limited only to a free trade area with a common external tariff, its strength would be severely diminished once the FTAA is established, since once tariffs are eliminated in the three Americas – North, Central and South – the ability of the sub-region to distinguish itself from the rest of the countries in the continent will naturally be undermined. That is, for MERCOSUR to maintain its strength once the FTAA is established, it should become far more than an FTA. In other words, if its member states are incapable of deepening the agreement, the creation of the FTAA represents, in practice, the death of MERCOSUR.* Under this first alternative, MERCOSUR would be a bloc with scant supranationality, diluted in a larger free trade area. MERCOSUR would thus be left with few policy-making powers *vis-à-vis* the large multinationals and the hegemonic global centers.

Alternative B, associated with a more dynamic approach, implies that MERCOSUR would still play an important role characterized as: (i) a response to the question of what its global role would be in 10 or 20 years time; (ii) a medium-sized economic power *vis-à-vis* the large blocs consisting of NAFTA, the European Union and the Asian countries, with a consolidated supranational dimension, representing one kind of power in the new world order; and (iii) an affirmation of regional identity, in all its aspects – economic, geopolitical and cultural. This alternative would be far more arduous, since it would demand negotiations in a number of areas and the development of an extensive working agenda, as well as the diplomatic effort implied by the FTAA process. However, it would avoid the risks associated with alternative A.

This dynamic approach in favor of integration, regardless of whether a single currency is introduced as the final stage of the process, should result in concrete progress being made over the next few years, such as (a) establishing mechanisms for macroeconomic coordination between countries, without which the barriers to intra-subregional trade integration could proliferate; (b) further studies of the creation of a common citizenship, through the introduction of a MERCOSUR passport; (c) a joint effort by the countries of the sub-region to harmonize, for example, their tax, labor and capital market legislation.

If this more dynamic approach is not adopted, in an extreme case, as Argentina, Brazil, Paraguay and Uruguay eventually decide to join the other parallel processes of trade liberalization that are making good progress, the question "what is MERCOSUR for?" will become unanswerable and the bloc will lose its *raison d'être*. The next section will examine the conditions that MERCOSUR must meet to continue as a separate entity in the context of the new global environment of the next few decades.

III. The Parallels with Maastricht: a Taxonomy of the Interpretations of the Validity of the European Single Currency

The natural source of inspiration for the proposal for monetary union in MERCOSUR is Europe, which introduced the euro as a fiduciary currency in 1999. The euro will become an exchange mechanism, substituting national currencies, in 2002. In respect to the process of European integration, Schweickert, Zahler and Jessen indicated

that, "the early start of the Economic and Monetary Union and the creation of a single currency serves as a splendid learning opportunity for Latin American and Caribbean countries engaged in regional or subregional integration schemes" (Schweickert, Zahler and Jessen [1997] p. 30, emphasis in the original). It is, therefore, useful to identify the factors that determined this process and the parallels that can be made with the MERCOSUR countries. There are several interpretations in relation to the reasons behind the agreement to establish monetary union that resulted in the 1992 Maastricht Treaty.

A Solution for the Inconsistencies Associated with Incomplete Integration

According to this interpretation, monetary union is the natural solution for the problems arising from incomplete integration – that is, without monetary integration – and a mechanism for improving the efficiency of the economies that constitute an FTA. According to Giavazzi and Giovannini, "... the survival of the current system of fixed but adjustable parities must be ascribed to the operation of capital controls. However, capital controls prevent financial integration. Thus, financial integration requires that European countries give up realignments altogether, moving toward a system of credible, and thus irrevocably fixed, exchange rate. This is a monetary union" (Giavazzi and Giovannini [1991], emphasis added). At the same time, according to this view, monetary union would be nothing more than the logical outcome of the prior process of integration. This is the origin of the *"one market, one money"* principle set out by the European Economic Community a few years before Maastricht (ECC [1990]).[8]

A Mechanism for Preventing Reverses in the Integration Process

This view is supported by, among others, Collignon, Bofinger, Johnson and De Maigret: "In the long run, distortions in the structure of relative prices misdirect the use of resources and draw capital and labour into uses which remain profitable only so long as inflation accelerates. This effect is damaging for the functioning of the economy ... The same applies to instability resulting from exchange rate instability in the Single Market. The uncertainty which dominates market relations based on different currencies introduces the need for hedging operations and drives a distorting wedge between prices, which leads to a misallocation of resources. An integrated market, where goods and services are allowed to circulate freely and information is readily available, but where the value of commodities is expressed in separate currencies, is therefore necessarily suboptimal and could disintegrate again if distortions turn welfare gains into losses ... Only with full economic and monetary union and a single currency will the informational distortions that are implicit in a multicurrency standard be eliminated ... [for] ... achieve a truly efficient and Single Market" (Collignon, Bofinger, Johnson and De Maigret [1994] p. 89-90, emphasis in the original). With the development of the European "snake" mechanism of exchange rate parities in the European Community at the end of the 1980s, the latter reached a crossroads, since the internal logic of unification required the abolition of capital controls. However, this would have caused greater exchange rate volatility in Europe. Western Europe had thus to choose between exchange rate flexibility or monetary union. Even the early critics of EMU thus recognized that "... wider exchange rate swings would compound the adjustment difficulties associated with completing Europe's internal market. If national industries under pressure from the removal of barriers to intra-European trade find their competitive position eroded further by a sudden exchange rate appreciation, resistance to the implementation of the Single European Act (SEA) would intensify. The SEA might be repudiated. In this sense and this sense alone, monetary unification is a logical economic corollary of factor - and product – integration" (Eichengreen [1993] p. 1321-1357, emphasis added).[9]

An Opportunity to Secure Greater Credibility

This interpretation is based on the following premises: (i) low inflation is a positive long-term condition for economic growth; (ii) the aim of achieving and maintaining low inflation requires consistent fiscal and monetary policies; (iii) the success of such policies is associated with an institutional environment that allows economic policy decisions to be isolated from the demands of the political cycle. EMU is thus a mechanism that "ties the hands" of the countries of the agreement. It even serves as an "alibi" when these adopt unpopular measures, since the "blame" falls on an external agent of that country. In certain respects, this is equivalent to "exporting" the Bundesbank's credibility to the other countries that, together with Germany, make up the monetary union. This point of view is held by, among others, Giavazzi and Pagano [1988] (before the Maastricht Treaty), as well as by Sandholtz [1993]. In respect to the increase in credibility conferred on those national policies directed towards fighting inflation – understood as the most efficient basis for long-term growth – Sandholtz notes that "... European governments favored European Monetary Union because it would provide the highest possible level of credibility; ... monetary union would be more credible than unilateral pegging to a strong currency because the latter could be undone at any time, even in response to temporary electoral concerns. In fact, monetary union would provide price stability for governments that would be unable, for domestic policy reasons, to achieve it on their own" (Sandholtz [1993] p. 35). This view was subsequently backed up by the following: "For governments that found it difficult domestically to achieve monetary discipline, European Monetary Union offered the chance to have it implemented from without. Governments could even escape the blame when tight monetary policies pinched" (Sandholtz [1993] p. 38, emphasis added).

A Combination of Complementary National Interests

This interpretation highlights a combination of complementary national interests that led to the decision to create EMU. On the one hand, a group of European countries, led by France, were interested in weakening the domination of Germany in the economic decision-making that affected their economic performance. In practice, in the period of the Maastricht agreement, the countries of Western Europe were, without exception, subordinate to German monetary policy. Establishing an EMU in which all the countries affected by this policy would be represented was a way of sharing responsibility for European monetary policy. In parallel (and this helps to understand not only the support of these countries, but principally German backing for the agreement), monetary union – after the fall of the Berlin Wall and specifically in the context of German unification – was a mechanism for guaranteeing European peace and unity and of assuring the rest of Western Europe that Germany would continue to be part of the same bloc and would preserve the communitarian spirit that marked the postwar European integration process. At the same time, Germany's loyalty to the integrationist philosophy during the initial negotiations on EMU obviated the danger that France would use its political veto to block German unification. The then President of the Bundesbank, Helmut Schlesinger, acknowledged that EMU would not have significant economic benefits for Germany and that German support for the project was strictly political in nature.

Some of the incentives evident in the European experience are not present in the case of MERCOSUR, although others assume greater importance. In particular, the problems associated with incomplete integration did not have the same consequences as outlined above and there is nothing that comes close to matching the concerns in Europe over German expansionism. However, the risks of an incomplete integration process reversing itself, are real and the commitment to stability associated with institutional

change, has potentially many more benefits – in terms of a reduction of interest rates and the creation of a favorable environment for investment – for Latin America countries, which struggle against a track record of high inflation, in contrast to Europe's decades-long history of low inflation.

IV. The Necessary Conditions for Introducing a Single Currency [10]

The introduction of a single currency should be associated with a *latu sensu* single market. This means, among other things, that the labor market formed by the geographic space using the same currency is characterized by mobility of factors, thus avoiding differences in unemployment rates. In practice, however, this is difficult to achieve, and sometimes even within countries it is possible to find markedly different regional unemployment rates. Nevertheless, in theory, the literature on optimum currency areas (OCAs) emphasizes the following necessary aspects to justify the creation of a single currency:[11]

i) Free movement of labor factors between countries. This makes it possible to react to external shocks in a uniform manner. The constraints to this mobility include legal, economic and cultural factors, such as, for example, language. The most important economic factor concerns the difficulty of harmonizing national pensions systems and validating in the other countries the contributions made by each worker in their country of origin.

ii) High level of intra-regional trade. Countries that do not trade with each other have no incentive to adopt a single currency. By contrast, if 100% of the trade of a group of countries is intra-subregional, monetary union is practically a precondition. After decades of integration, Europe has increased its intra-subregional trade, this being one of the most important factors in favor of integration.

iii) Similarities in the types of shock that affect a group of countries. A region which, for example, consists of large oil importers as well as important oil exporters is not a good candidate for monetary integration, since variations in the price of oil affect these countries in opposite ways. On the other hand, countries with similar features tend to confront shocks in the same manner and are therefore, according to this point of view, good candidates for monetary union.[12]

Therefore, an optimal exchange rate area – defined as a geographic space well suited to adopting a single currency – is one in which the countries that are included in it share characteristics that make them vulnerable to the same types of shock, "... so that policies that are generally appropriate in one country are also appropriate for other member countries" (Englander and Egebo [1993] p. 11).

It is precisely this factor that makes labor market flexibility in the countries involved in monetary union especially important. As Englander and Egebo again stress "with exchange rates fixed, the option of changing relative prices quickly via nominal exchange rate changes is not available. Hence, real exchange-rate adjustments, when needed, must be achieved through changes in relative costs and prices. However, if wages and prices are not flexible internally and credibility effects do not greatly affect wage and price decisions, such adjustment may require large shifts in capacity utilisation and employment. In general, <u>the greater the degree of wage and price rigidity, the more the output and employment response that would be needed to alter relative prices</u>" (Englander and Egebo [1993] p. 9, emphasis added).

At the same time, as highlighted by Bovenger et al, the fact that the mobility of the labor factor is limited, and that there is a certain rigidity of prices and wages, implies that once the possibility of changing intra-subregional exchange rate parities disappears – from a group of countries in a monetary union – the member countries of the agreement need to have some flexibility in their respective fiscal policies. They can thus combat future shocks that could affect them in different ways. (Bovenger et al [1991]).

In this context, what is the situation of the MERCOSUR countries? The motives behind their possible adoption of monetary union lies fundamentally in the strengthening of an institutional environment favorable to long-term price stabilization – including a single and independent central bank; the setting of limits on the relationship between the fiscal deficit and GDP; and in having low inflation targets. Independently of this, however, there is evidence that certain conditions necessary for the creation of a monetary union are gradually being met, although others are not. After 1991, intra-subregional trade grew more rapidly than trade with the rest of the world. In particular, MERCOSUR's two largest economies, Brazil and Argentina, have an external sector with relatively similar characteristics in terms of their dependence on external capital flows. They thus tend to be equally sensitive to fluctuations in the international prices of their export goods, to world economic growth, external interest rates and/or the conditions of liquidity of the international financial market. There are also many issues on which MERCOSUR must make progress. These will be discussed in a subsequent section of this article.

V. Macroeconomic Convergence in the MERCOSUR Countries

In the last few years, the process of macroeconomic convergence of the MERCOSUR countries – understood as the increasing similarity in the performance of the various economies of the sub-region – has deepened. This in an important factor when considering the unification of their currencies.

Table 1 supports what was previously noted on the growing similarity of certain performance indicators in the Argentine, Brazilian, Paraguayan and Uruguayan economies. These figures show GDP growth rates over the last five decades and, in the last line, their standard deviation (SD) in each year.[13] Graph 1 was drawn up on the basis of the last line of this Table.

This graph presents the running mean – for 10-year periods – of the SD in the GDP growth rates of the MERCOSUR countries. Therefore, the values included in these correspond to the arithmetic mean, for 10-year running periods of the standard deviation of the last line of Table 1. The numbers of the graph, in each year, refer to 10-year periods ending in the reference year – for example, 1980 should be interpreted as the average of the SD of the last line of Table 1, for 1971-1980. The graph shows the SD trend between the total growth rates of the four countries. A fall in the indicator means that the GDP growth rates of the four countries tend to differ less between them in the longer term. The graph *shows a clearly downward trend in the standard deviation*. This points to a greater degree of similarity in the behavior of the economies of the region. This trend is reflected in the following elements:

i) the average SD between 1989 and 1998 is the lowest in the series under consideration;

ii) on the basis of the means of the last line of Table 1, for fixed 10-year periods, there is an average fall in the SD of 4.7 in 1971-1980, 4.1 in 1981-1990 and 2.8 in 1991-1998 (eight years in the latter);

iii) the average SD fell consecutively during the last five observations.

In addition, Table 2 shows:

(a) in general terms, the trend towards lower inflation in the region, close to international levels;[14] and

(b) fewer differences between the inflation rates of the four countries.

Table 1

GDP Growth Rates of the MERCOSUR Countries
(percentages)

	1947	1948	1949	1950	1951	1952	1953	1954	1955	1956	1957	1958	1959	1960	1961	1962	1963	1964
Argentina	3.7	1.2	-4.6	1.6	3.9	-5.1	5.4	4.1	7.1	2.8	5.1	6.1	-6.4	7.8	7.1	-1.6	-2.4	10.3
Brazil	2.4	7.4	6.6	6.5	5.9	8.7	2.5	10.1	6.9	3.1	8.1	7.7	5.5	9.8	10.3	5.2	1.6	2.9
Paraguay	-13.1	1.1	16.8	-1.7	1.9	-1.7	2.8	1.7	4.6	4.2	4.6	5.7	0.4	0.1	4.8	7.0	2.7	4.3
Uruguay	6.7	2.6	3.7	3.1	8.2	-0.4	6.5	5.7	1.6	1.7	1.0	-3.6	-2.8	3.5	2.9	-2.2	0.5	2.0
Standard deviation	8.87	2.96	8.83	3.40	2.70	5.89	1.96	3.54	2.56	1.03	2.91	5.12	5.05	4.35	3.19	4.68	2.19	3.74

	1965	1966	1967	1968	1969	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
Argentina	9.1	0.6	2.7	4.3	8.6	5.4	4.8	3.1	6.1	6.5	-1.4	-2.9	6.4	-3.4	6.7	0.7	-6.2	-4.2
Brazil	2.7	3.8	4.9	11.2	9.9	8.8	13.3	11.7	13.9	9.8	5.7	9.2	4.7	5.0	6.4	7.2	-1.6	0.6
Paraguay	5.7	1.1	6.3	3.6	3.9	6.2	4.4	5.1	7.8	8.3	4.8	7.1	12.7	11.3	11.4	11.4	8.7	-1.0
Uruguay	1.1	3.4	-4.1	1.6	6.1	4.7	-1.0	-3.3	0.9	1.6	3.6	2.8	1.2	5.3	6.2	6.0	1.9	-9.4
Standard deviation	3.53	1.61	4.61	4.18	2.67	1.79	5.91	6.18	5.36	3.57	3.17	5.34	4.81	6.04	2.49	4.41	6.28	4.41

	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998
Argentina	3.0	2.7	-4.4	7.3	2.6	-1.9	-6.2	0.1	10.0	8.9	5.8	8.3	-3.1	4.4	8.4	4.0
Brazil	-3.4	5.3	7.9	7.5	3.5	-0.1	3.2	-4.4	1.0	-0.5	4.9	5.9	4.2	2.8	3.7	0.2
Paraguay	-3.0	3.1	4.0	0.0	4.3	6.4	5.8	3.1	2.5	1.7	4.0	3.0	4.5	1.1	2.6	0.0
Uruguay	-5.9	-1.1	1.5	8.9	7.9	0.0	1.3	0.9	2.9	7.4	3.1	5.5	-2.0	5.0	5.1	2.5
Standard deviation	3.77	2.66	5.16	4.01	2.32	3.64	5.16	3.15	4.02	4.49	1.16	2.17	4.01	1.75	2.52	1.92

Source: ECLAC

Table 2

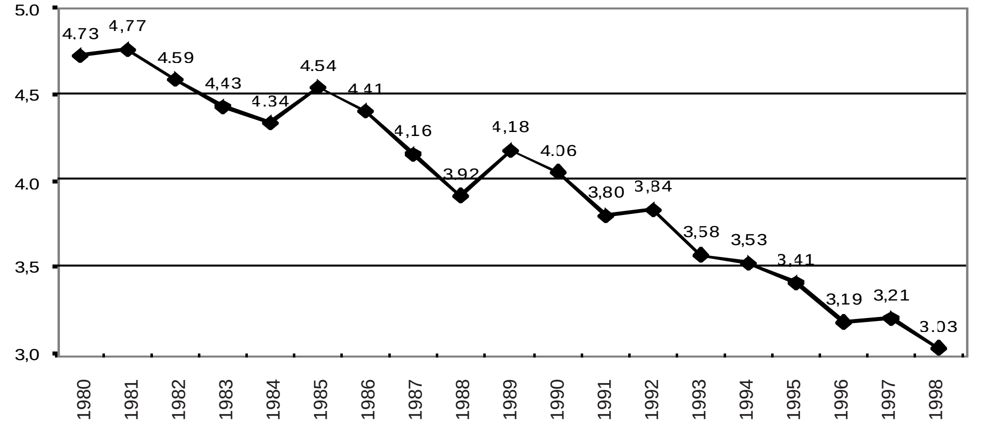
MERCOSUR Inflation (CPI) January/December
(Percentajes)

Country	1993	1994	1995	1996	1997	1998/p
Argentina	7.4	3.9	1.6	0.1	0.3	0.9
Brazil	2,489.1	929.3	22.0	9.1	4.3	2.5
Paraguay	20.4	18.3	10.5	8.2	6.2	16.0
Uruguay	52.9	44.1	35.4	24.3	15.2	9.4

Note: p/ - Provisional.
Source: ECLAC.

Graph 1

RUNNING MEAN OF THE STANDARD DEVIATION OF THE GDP GROWTH RATES OF THE MERCOSUR COUNTRIES (10- year periods))



Source: Table 1

Finally, it is worth noting the similarities in the public debts, measured as a percentage of GDP, of Argentina and Brazil. These two economies are clearly the strongest in the sub-region and their public debt, excluding the monetary base, accounts for some 40% of GDP (slightly less in Argentina and slightly more in Brazil). This point is especially important for the implementation of a successful monetary union. If debt levels had been very different *vis-à-vis* GDP, it would have been necessary to generate compensatory primary results in those countries with higher debt levels and, in that case, the taxes introduced with this aim in mind would have hindered the entry of capital and/or prompted capital flight. This would have reduced the internal consistency of policies in the sub-region and made it more difficult to administer exchange rate and monetary policies in the monetary union. The similarities in the respective public debt levels of the biggest members of that possible union is, therefore, a positive factor for its success and for its unification.

VI. What has Changed since 1997?

As stated above, the idea of establishing monetary union in MERCOSUR was first mooted in 1997. What has changed since this idea was first raised two years ago? Or, to put it differently, has the idea of monetary union really strengthened in the 1997-1999 period. In this regard, seven important elements should be taken into account, all of which point towards monetary union:

i) The deterioration in relations within the bloc *owing to a series of trade frictions*. Curiously, this could be viewed by some skeptics as a clear sign that monetary union is nothing more than a utopia. However, the opposite is true, since the fact that integration has until now been limited to trade has prevented the member countries from adopting commitments associated with greater integration (commitments which invariably imply concessions, choices and sacrifices on the part of the members). This has created a space in which protectionist lobbies of all types proliferate. Although the metaphor cannot be sustained academically, it is valid to compare MERCOSUR to a pair of lovers who continue their relationship without committing themselves to marriage. This relationship is marked by minor conflicts. The point comes, therefore, when the only way to put an end to these

conflicts is for the couple to commit themselves to deepening the relationship and, consequently, to agree to make compromises that will benefit the union. Similarly, it is likely that problems such as those that affected the sugar sector in Argentina, or the protests against Brazilian phytosanitary controls, will only be resolved when the sectors involved realize that these commitments are necessary in order to make progress in more important areas.

ii) The *devaluation of the real*. Sharp fluctuations in the real parities between currencies in one area, within which there is free trade, is obviously a worrying factor that works against intra-subregional trade. It is not a coincidence that after the devaluation of the lira in 1992 some European member states demanded retaliatory measures against goods imported from Italy. Similarly, after the devaluation of the real, Argentine producers made similar demands, such as the introduction of a specific tariff against Brazilian goods, safeguard measures, and the establishment of quotas. Although these measures were temporarily justified, they ran counter to the spirit of free trade that has marked MERCOSUR since its creation. In the last resort, monetary union is the only way definitively to end these types of problems and risks, as well as to avoid a reverse of all that has been achieved in the sub-region in respect to strictly trade related matters – which is related to point (i) above.

iii) The *consolidation of the euro*. In 1997, Luxembourg was the only country complying, *strictu sensu*, with the Maastricht criteria, as distinct from the fiscal problems that affected the "patrons" of the euro – France and Germany – and doubts over the introduction of the euro as a fiduciary currency on 1 January 1999. Two years later, the euro was adopted as a fiduciary currency in 11 of the 15 members of the European Union. It is feasible to believe that once the euro begins to operate as a physical currency in 2002, the "euro zone" will be enlarged to include 15 countries – with the inclusion of the United Kingdom, Sweden, Denmark and Greece. Most experts believe that, if the negotiations for the accession of six new members to the European Union – involving those countries in the old Eastern European bloc that made successful transitions to capitalism – are concluded satisfactorily, it is likely that in the next decade the euro will become the currency of an even larger bloc, which could include 21 countries.

iv) The *change in world perception* after the crisis that affected the emerging economies in 1997/1999. Until recently many authorities and scholars, especially in the United States, had reservations about European monetary union. In this context, any proposal for monetary union in MERCOSUR, with a much more recent integration history than Europe's, was seen as something that was simply unattainable and not even worth discussing. However, after the crises and devaluations in South-East Asia (1997), Russia (1998) and Brazil (1999) the key idea that there should be fewer currencies – as one of the mechanisms that would help avoid future crises – became increasingly popular in different fora and gained a certain academic respectability. The idea of monetary union in MERCOSUR, therefore, no longer began to be seen as a simple utopia.

v) The *favorable evolution of the situation in Brazil*. It is clear that, if the integration process is to be deepened, it is essential that Brazil achieve macroeconomic balance. In 1997, there was serious concern about the increasing external and fiscal deficits posted by Brazil until then and in 1998. However, data for 1999 suggest an improvement in the next few years in the relationship between: public sector borrowing requirement/GDP and current account deficit/GDP. This is the result of fiscal adjustment measures, on the one hand, and the devaluation of the real on the other.

vi) The *fall in sub-regional inflation*. Monetary union will not be possible without harmonizing the inflation rates of the countries in the sub-region and, preferably, lowering these to the rates of the industrialized countries. In this respect, inflation was still high at the beginning of 1997, with inflation in Brazil and Paraguay standing at close to 10% in 1996 and above 20% in Uruguay. Two years later, however, the outlook turned more

favorable although, strictly speaking, there were reverses in Paraguay and inflation in Brazil increased again in 1999. The fact that the exchange rate in Brazil devalued by 80%, in the peak of the overshooting period, and will probably end 1999 with a devaluation of 45%, with a pass-trough of some 0.15, and with consumer inflation of under 7%, clearly shows that stabilization in the country is a stronger phenomenon that at first thought, with inflation likely to fall again in 2000 and possibly reaching OECD convergence in 2001. At the same time, the success of the Uruguayan government's anti-inflation policy has been notable, with a similar convergence likely to occur in the next few years.

vii) The *change in the situation in Uruguay and Paraguay*. In 1997, if the sub-regional initiatives in favor of monetary integration had proved successful, it would have been highly likely that this would have consisted of a bilateral initiative between Brazil and Argentina, with the subsequent inclusion of MERCOSUR's smaller members. At that moment, high inflation in Uruguay and doubts over Paraguay's status in the bloc – threatened by the risk of institutional breakdown because of the political conflicts in the country – would have made it difficult for these two countries to join the project. Meanwhile, the fall in the inflation rate in Uruguay and the resolution of the Paraguayan crisis, which culminated in the formation of a coalition government, helped make MERCOSUR a more coherent and homogenous bloc, both economically and politically.

VII. The Viability of Monetary Union as a Long Term Project

The natural objection to the adoption of such an ambitious proposal as the monetary union of a group of countries is based on the view that, in the case of MERCOSUR, the conditions necessary for such a project do not exist – that is, the development of a common market that goes beyond a CET, specifically the coordination of macroeconomic policy and the harmonization of national tax, labor and financial legislation. In short, this objection could be expressed in the idea that "MERCOSUR cannot achieve in 10 years what it took Europe four decades to build". There are, however, four key arguments to consider:

i) The intellectual idea behind European monetary union was the famous 1970 Werner Report, presented 13 years after the 1957 Treaty of Rome, which gave rise to the European Economic Community. The recommendations of the report, however, were dropped after the 1973 oil shock and, specifically, because of the subsequent rise in inflation. Similarly, although MERCOSUR dates back to 1991, its origin lies in the 1986 bilateral agreements between Brazil and Argentina. Therefore, *the view that MERCOSUR is advancing more quickly than the European Union with respect to the unification project is erroneous*: the most serious discussion of monetary union is taking place in 1999, 13 years after these agreements were signed and, coincidentally, this is exactly the same length of time that separated the Treaty of Rome (1957) from the first formal mention of monetary union in the Werner Report.

ii) No one views monetary union as a short-term project. All the member states acknowledge that *this is not a proposal than can be implemented immediately* but one that, after all the stages have been completed, could probably become a reality within 10-15 years.

iii) In 10-15 years time, MERCOSUR will be younger than the European Union, *but the historical environment is different*. In the 1990s, the world economy underwent a more rapid process of transformation than that experienced from the 1960s until the 1980s, and this trend will probably continue in the coming decade. If Europe had four decades to advance to what it is today within a world that moved more slowly, it is unlikely that MERCOSUR will have the same opportunity without running the risk of missing the train of history.

iv) Although monetary union can include Uruguay and Paraguay, it is clear that the main difficulty lies in reconciling the interests of Brazil and Argentina. However, the economic,

political and diplomatic engineering necessary for integrating the economies of only two countries such as Brazil and Argentina, although difficult, is simpler than the integration of the 11 countries that form the "euro zone", including the latecomers of the "Club Med". Taking into account the blocs as a whole and considering the number of countries participating in MERCOSUR (4) and the European Union (15), it is clear that it is easier to *reconcile the interests of four members than of 15.*

In effect, eventual monetary union, so long as it meets a series of prerequisites, could provide benefits for all the MERCOSUR countries. Independently of this, however, it could have a significant impact on the bloc, specifically on the two largest members.

Monetary union would have four main benefits for the sub-region as a whole:

a) The transformation of the sub-region into an *export platform towards third countries*. It is necessary to take up again the original aims that motivated the creation of MERCOSUR. These included transforming the bloc into an export platform, based on a market that guaranteed those companies based in the sub-region a scale of production sufficiently large to enable them to enjoy benefits of scale that would allow them to operate at reduced costs. This project was frustrated; MERCOSUR continues to be a marginal exporter in global terms, in part because it is an incomplete market, since exchange rate instability continues to be an economic factor in sub-regional investment decisions. The creation of a *single market worth US$ 1 trillion*, including the four economies of the sub-region, would be an extremely important factor in persuading those large business groups that wish to meet world demand to invest in the sub-region.

b) *Reduction of risk*. A commitment to satisfy minimum prerequisites of macroeconomic stability would contribute, *per se*, to reduce "country risk". As the countries of the bloc each begin to assume the same kinds of commitments, investors would begin to view the still negative Latin American "brand" more positively, thereby reducing MERCOSUR's "region risk". Finally, once exchange rate policy is perceived as being managed by an independent sub-regional central bank, the discretional component associated with political interference in exchange rate policy would disappear. This would, in turn, reduce the sub-region's "exchange rate risk".

c) A *fall in interest rates*, in relation to the above: since the basic interest rate of an economy is affected by external interest rates and by the risk components mentioned above, once these are overcome the interest rate would fall dramatically over time, coming close to those rates prevalent in the more advanced economies, as a result of lower risks in the sub-region.

d) An *increase in new investment*. Greater confidence about long-term stability and a reduction in interest rates would serve to promote investment in the sub-region by groups that operate on a global scale, which would begin to show greater interest in the sub-region. Similarly, the new environment would help stimulate domestic investment.

This last point would be particularly important in the case of Brazil and Argentina, where monetary union would increase their investment potential, since local investors would probably be those that would most benefit from an investment boom in the sub-region.

As the main member of MERCOSUR, Brazil would be the natural beneficiary of the political strengthening of the bloc – for example, in negotiations and international fora – that monetary union would imply. Rather than being an isolated voice, without the strength to impose itself in difficult multilateral external negotiations, it would be the spokesman of a bloc that is increasingly important on the world stage.

On the other hand, monetary union would benefit Argentina by ending the uncertainty over Brazil's exchange rate policy, reducing the impact of the so-called "Brazil dependency". Although 30% or more of Argentina's exports will continue to be directed towards Brazil, it would no longer suffer the internal problems associated with a unilateral

devaluation by Brazil since, once there is monetary union, bilateral parity would, by definition, remain frozen after the respective national currencies disappear.

VIII. Monetary Union, Dollarization and Currency Board

It is important to differentiate between the proposal that is being made here – monetary union in MERCOSUR – and the idea of dollarization of the economies of the sub-region or the countries of Latin America as a whole, that is being discussed in some international circles (Hausmann et al [1999]). In fact, the same logic that is used to advocate monetary union can be used to support the proposal to dollarize the economies of the region. However, the implications are completely different.

Dollarization is not an advisable strategy, since there are five types of problems associated with it. These problems are acknowledged even by its proponents:[15]

a) The *difficulty of absorbing real shocks*.[16] Monetary union "freezes" the "relative parity" within the sub-region, but is perfectly consistent with the possibility of modifying the exchange rate of the sub-region in case of external shocks, such as those involving prices, interest rates or international liquidity conditions. This is not possible with dollarization. Eichengreen's (1998) particularly rigorous observation, originally presented as a criticism of the idea of a regional currency board, is also applicable *ipsis litteris* to the issue of dollarization, "...pegging each of the Mercosur currencies to a common external numeraire like the US dollar is an extremely indirect way of solving the problem of intra-Mercosur exchange-rate variability. <u>It forecloses not just intra-Mercosur exchange-rate changes as an instrument of adjustment but also, in effect, changes in the exchange rate vis-a-vis the rest of the world"</u> (Eichengreen [1998] p. 24, emphasis added).

b) The *lack of a "lender of last resort".* There is apparently little possibility of a financial crisis hitting the MERCOSUR countries in the near future. If this were to occur, however, both under the present system of multiple currencies and in the system of monetary union, the monetary authorities could act as a lender of last resort in order to inject liquidity into the system. On the other hand, and given that the MERCOSUR countries do not issue dollars, this would not be possible in the case of dollarization. Although it could be possible in the context of an agreement with the United States, it is unlikely that the US authorities, especially the Federal Reserve, would approve such action.

c) The *loss of income from seigniorage* – emission of money – and from the interest of international reserves. In a situation in which national currencies are substituted by a foreign one, the concept of international reserves would become meaningless. These losses, especially those associated with interest based on reserves, would be significant for the countries involved. In this case, an international treaty with the United States could lessen the impact of the problem, through some kind of financial compensation for the countries of the sub-region. However, as in the aforementioned case, it is doubtful whether this support, which would be provided by US taxpayers, would be so easily forthcoming.

d) The *difficulty of sharing sovereignty*, or what Hausmann et al [1999] refer to as "governance structure" – that is, the resistance to US institutions being "absorbed" by other countries or, alternatively, to the United States sharing sovereignty with neighbors that, in its view, are not trustworthy. In concrete terms, it is difficult to imagine the Federal Reserve agreeing to having a director on its board nominated by, for example, one of the MERCOSUR countries.

(e) The *lack of political support* for the proposal. Despite the problems highlighted above, situations can arise where the relationship between a country and the United States is so close that the benefits of creating a monetary union with it are greater than the costs. However, for this to occur, several factors should be taken into account, such as public

opinion and the view of political leaders. In this respect, it is reasonable to affirm that the dollarization proposal has been well received in certain small Central American countries and even in Mexico. The latter has already developed very close ties with the United States, has a vast common border, and has historically been the source of mass labor migration to the United States. Therefore, a significant section of Mexican society has relatives resident in the United States and many Mexicans receive remittances from families that have emigrated to the United States. On the other hand, it is unlikely that the proposal would be well received in Argentina, and even less so in Brazil, whose ambitions to become a leader in the region and to differentiate itself from the United States are well known.

In general, it is valid to assert that in Europe the euro has been associated with the creation of *new* institutions – particularly the European Central Bank – to support a *new* currency. This implies the definition of *supranational sovereignty* in which all members have a voice and a vote. In the case of the dollarization of one or more Latin American countries, however, these would probably be *adhering* to the institutions, currency and sovereignty of another country, the United States. Dollarization would, therefore, result in geopolitical circumstances completely different from those in Europe.

Among the various possibilities associated with the adoption of monetary union based on a new currency and dollarization, an alternative has been presented by the former Argentine Economy Minister Domingo Cavallo, who proposed that Argentina and Brazil adhere to a currency board system (Cavallo, 1999). This alternative, however, has not only been criticized on the same grounds as dollarization, but is not supported by Brazil. Regardless, if a single currency is adopted in the sub-region and Argentina continues to apply its fixed exchange rate system, it would be necessary to develop a transition mechanism to minimize the likelihood of a speculative attack prior to defining the conversion rates between one currency and another. A mechanism could be introduced whereby the bilateral peso/real parties would be maintained rigidly during a certain period of time prior to the two currencies disappearing.

IX. A Proposal for a Working Agenda

The basic proposition of this study is that the coordination of macroeconomic policy – essential for the viability of monetary union – is necessary to avoid reverses and to promote new advances in the MERCOSUR integration process. It is also vital to prevent the integration process – hereto limited to intra-subregional free trade, with a common external tariff – from stagnating. An empirical analysis of MERCOSUR makes it impossible to reject the hypothesis that there is an inverse relationship between the variability of the intra-subregional exchange rate and the intensity of trade flows within MERCOSUR. This hypothesis was apparently confirmed by the recent experience of the devaluation of the Brazilian currency. Consequently, the stabilization of the exchange rate parities between the member states, through greater macroeconomic coordination, could have a positive impact on intra-subregional trade flows (Abreu and Bevilaqua [1995]). This could eventually lead to monetary union, which is in effect an extreme form of stabilization of these parities.

For such an ambitious proposal to have any chance of success, the MERCOSUR countries obviously need to make considerable progress towards harmonizing their respective national legislation, principally in the areas of tax, labor and capital markets.[17]

However, it is first necessary to define a three-year (2000-2003*) working agenda*. This would operate on different levels and consist of a time period during which the principal members of MERCOSUR would not be subject to the discontinuities associated with presidential elections. The objective would be to achieve the necessary conditions to be able to sign an agreement in the final year of the present Brazilian government (2002). This

agreement would set the final year of the subsequent government (2006) as the deadline for establishing a date for monetary union.[18] At present, the steps that need to be taken are so many and so large that the definition of dates is still premature; thus the proposal to work towards a position in which these dates can be defined more precisely within a few years.

It is worth noting that 2002 is not being presented as the year in which this process will begin, but rather as the year in which the MERCOSUR countries will commit themselves to define, in 2006, the date of monetary union, which would probably not take place before 2010. If this were the case, 2006 would represent for MERCOSUR what 1992 represented for European unification – a kind of "initial sprint" in the race towards unification. However, in this case, given that the process involves a small group of countries with certain "know-how" in currency exchange rates, it may not be necessary to wait 10 years between this start up and the onset of the physical circulation of a new currency, as occurred in Europe – where this stage will only start in 2002, a decade after the Maastricht Treaty. In MERCOSUR, it could happen in a shorter period. *A realistic date for introducing a single currency in the sub-region would be between 2010 and 2015*. If this process is completed near to this latter date, then monetary union would have been achieved three decades after the start of Argentine-Brazilian integration in 1986 – when the seed of MERCOSUR was first sown – a time period that is not much shorter than the four decades in Europe that separated the 1957 Treaty of Rome from the recent adoption of the euro as a fiduciary currency.

Monetary integration would thus include some key dates. The first is 1998, when the MERCOSUR countries, through their presidents, signed the Act of Ushuaia at the XIV meeting of the Common Market Council in which "... the MERCOSUR leaders announced that the process of deepening the customs union should be completed through new measures capable of: (a) defining fiscal and investment disciplines, (b) working towards the harmonization of macroeconomic policies and (c) <u>considering other aspects that could in the future facilitate the establishment of a single currency in the Southern Common Market</u>" (emphasis added). Although the declaration is ambiguous, it was important in that it was the first explicit, official and joint mention of monetary union as a long term aim. The second key date is 2002, when this article suggests the countries should formally commit themselves to define before 2006 – the third key date – the date for monetary union, establishing an agenda on the progress that has to be made in the 2003-2006 period. A date for unification would be fixed once this agenda was successfully completed.

In the 2000-2002 period specifically, it is suggested that the working agenda focus on *three fronts*:

a) The *unresolved agenda*. The long list of strictly trade-related conflicts must be resolved, including those relating to the automobile sector, inclusion of the sugar sector in the negotiations, and the criteria for phytosanitary controls. The aim would basically be to "clean up the guidelines" on trade issues; create a "pure" free trade area; and avoid "perforations" in the CET. In this way, the discrepancies in relations within the bloc would be reduced, current differences would be eliminated and the road towards a "pure" CET would be defined before 2002. It would thus be hoped that the negotiations could make progress beyond mere trade issues from 2003. In this case, in the 2003-2006 period, the negotiations would involve the so-called "new issues", such as consumer rights, fair competition, government procurement, and the concept of "national treatment", issues which are complex but are in certain respects under the jurisdiction of the executive. It would also include legislative harmonization in the three areas already mentioned – tax, labor and capital markets – which would imply a greater parliamentary participation in the negotiations.

b) *Statistical standardization*. The decisions adopted at the 15 June 1999 presidential meeting on standardizing the criteria for defining and measuring the main macroeconomic variables in a more homogenous manner was an important step forward. The aim would

be regularly to publish a series of economic indicators that would: (i) make comparisons; and (ii) define a sub-regional measure for each of these indicators, which forms the basis of any ambitious integration effort.

c) *Macroeconomic coordination*.[19] It is proposed that in 2000 the MERCOSUR countries negotiate and approve a "Protocol of Macroeconomic Coordination", through which they commit themselves to put into practice, by 2002, a "three 3% ceilings" rule, establishing:[20]

- a 3% ceiling on inflation;
- a 3% GDP ceiling on the nominal deficit of the consolidated public sector; and
- a 3% GDP ceiling on the deficit of the current account of the balance of payments.

It is important to note that these parameters represent, as was stated above, *ceilings* and not *goals,* since some countries currently register better indicators than these. In other words, the aim is that in around three years the four MERCOSUR countries would: first, have an inflation rate close to international levels; second, respect the same public sector deficit established in Maastricht for the euro countries; and third, have certain modest external disequilibria goals, which is particularly important owing to the crises that affected Mexico in 1994-1995, the South-East Asia countries in 1997 and Brazil in 1999. *However, nothing will prevent each country from eventually deciding to adopt more or less rigid goals than the aforementioned ceilings.*

The benefits of a gradualist strategy, *vis-à-vis* a more rapid integration strategy, are two-fold. In the first place, it allows *sequential consensuses to be constructed* – that is, to establish successive agreements leaving particularly difficult issues to one side, so long as the issue is not of vital importance. A common exchange rate policy is one example. In particular, this is an issue that will have to be discussed in the future but is today a "taboo" subject in the negotiations – because of the differences between the exchange rate regimes in Argentina and Brazil, which neither country is willing to abandon – and it makes little sense to discuss it in the current stage of MERCOSUR's development. In second place, the strategy is *consistent with the respective national agendas* – that is, it seeks to define macroeconomic policies that will benefit the integration process but that will also help improve each country's economy.[21] Brazil, for example, will benefit greatly if it succeeds in lowering its fiscal deficit, in the same way that Argentina will benefit if the trend there towards external disequilibria is reversed.

By 2003, therefore, the MERCOSUR economies should become more homogeneous and share what is generically understood as "macroeconomic equilibrium". This would allow them to develop into attractive centers for foreign or domestic investment. The risks of speculative attacks against their national currencies should also diminish. In turn, this would induce the countries to speed up the integration process, advancing beyond the progress made thus far. In this context, a new working agenda for the 2003-2006 period would be established, and a date for monetary union could finally be defined by 2006.

In this respect, it is worth examining the essential condition necessary for the success of any ambitious integrationist initiative: the *political will* of governments, which need these initiatives to succeed – despite the fact that the "ideal" conditions for monetary union are still absent. Otherwise, in the absence of such a will, progress will simply not be made. As Mintz states, "It has often been argued that the conditions under which monetary integration might reasonably be expected to succeed are very restrictive. In fact, these conditions appear no more restrictive than the conditions for the establishment of a successful common market. The major, and perhaps only, real condition for the institution of either is the political will to integrate on the part of prospective members" (Mintz [1970] p. 33, emphasis added; quoted in Cohen [1993] p. 200). The importance of a gradualist approach is underlined by the latest events that have affected MERCOSUR and, specifically, the

bilateral relationship between Brazil and Argentina. In view of the arguments presented here, the answer to the question "does monetary union in MERCOSUR make sense?" is "yes". However, the answer to the question "is this a viable option in the short term?" is obviously "no", if one takes into account the long list of unresolved issues that still need to be settled before an official calendar towards monetary union can be defined. An example of the type of problem that needs to be resolved is that of the non-tariff barriers (NTBs) that the MERCOSUR countries have been increasingly introducing since 1996. The NTBs, which numbered 285 when the Protocol of Ouro Preto was signed, reached 350 in 1998.[22] Consequently, completing the free trade zone and the customs union is the first step to be taken if more ambitious integration proposals are to succeed. Once this stage is complete, and once the MERCOSUR economies become increasingly harmonized, with more adjusted and relatively homogeneous macroeconomic indicators, the issue of monetary union will feature more naturally on the agenda, following an evolutionary path very similar to that adopted by Europe over the last 40 years.

Notes

[1] Some of the issues discussed in this article, based on the idea of “shared sovereignty”, where first presented in Araújo (1992), although the issues were not examined closely.

[2] See IPEA [1997] for a strictly commercial analysis of initial developments in MERCOSUR and its prospects.

[3] In employing a metaphor used by a diplomat active in the integration process between countries of the region, MERCOSUR’s dynamism can be compared to water skiing, since “if the boat stops, the skier falls”.

[4] See Nofal [1998] for a critique of the proposal.

[5] Menem’s first reference to the issue, at the end of April 1997, was made soon after his bilateral meeting with his Brazilian counterpart Fernando Henrique Cardoso. In a subsequent press conference, Menem said that “we should begin to think about a common currency”. This statement was supported by the Brazilian president who said that “the moment for a common currency and for the convergence of macroeconomic policy will come (*Gazeta Mercantil*, 28 April 1997). Subsequently, Argentine Economy Minister Roque Fernández said in a statement made in that country that “in the future, we are going to focus on integrating the capital and financial markets, which will directly point towards a single currency. If we can commit ourselves to integrate the capital markets, making progress on a single currency will only depend on fiscal coordination in the different countries” (*Gazeta Mercantil*, 29 April 1997).

[6] See an article published in 1997 by President Carter’s former advisor on National Security Affairs (1977-1980) on the United States’ geopolitical strategy towards the countries of Eurasia which examines possible scenarios involving the countries of the former Soviet Union in the 2005-2010 period (Brzezinski [1997] pp. 19-24).

[7] See Almeida [1998] for a more detailed examination of the future of MERCOSUR.

[8] See Hoekman and Leidy [1993] for an analysis of the origins of and a discussion on some of the problems associated with European integration.

[9] The Single European Act of 1986 represented a commitment of the countries of the European Economic Community to create a common market totally free of barriers to the free circulation of goods, capital and labor within the member states of the agreement by the end of 1992.

[10] Apart from the general questions examined in this section, a process of unification implies resolving a series of operational issues relating to, among other things, the way in which financial markets operate. See Mc Cauley and White [1997] for a detailed analysis of the European case. See Begg [1997] for an examination of the specific issues of monetary policy in a process of unification between national currencies, also in reference to the European case.

[11] See Masson and Taylor [1992] for a survey of this literature, especially section III of these authors’ study.

[12] These three points, points (i) to (iii), are based in part on Schweickert, Zahler and Jessen [1997].

[13] The last line therefore corresponds to the standard deviation of the four values presented in each column.

[14] This trend will be negatively affected in 1999 by a rise in inflation in Brazil, the result of the devaluation of the real. However, the trend is likely to resume in 2000. In the case of Argentina, the modest increase is simply the consequence of natural fluctuations in the CPI variation, when this fell sharply to nearly zero.

[15] See Larraín [1999] for a balanced critique of the dollarization proposal.

[16] Some of the criticisms made against the dollarization thesis are also applicable to the currency board system. However, given the limits of this article, it is not possible to make any comments over the validity of such a system in the case of Argentina. What concerns us is simply to defend the arguments in favor of monetary union *vis-à-vis* the arguments in favor of dollarization.

[17] In respect to tax harmonization, for example, see González Cano [1996], Gandra [1997] and Gómez Sabaini [1999]. For an excellent, although relatively skeptical, analysis of the lack of financial integration in MERCOSUR see Abreu [1997].

[18] The importance of Brazil's political calendar lies in that, since the country is obviously the key to the success of the negotiations, it is vital that the terms of what is agreed is extensively discussed by its authorities in the years prior to their conclusion so that any final decision does not have to be taken by a recently elected government that has not participated in previous debates. This strategy is also relevant in the case of Argentina, whose president takes office in December, at the end of the first year of his counterpart in Brazil, where the presidential mandate began in January.

[19] See Strauss-Kahn [1997] for a discussion on the different alternatives for coordination.

[20] This focus is consistent with the caution that has characterized the initial negotiations in the bloc on the proposal for monetary union. This caution was highlighted by Brazilian President Fernando Henrique Cardoso when he said: "Without fiscal responsibility healthy integration cannot be achieved. A common currency will never be introduced without very serious prior efforts which economists call fundamental... Without solid fundamentals, the single currency [is] an illusion" (*Jornal do Brasil*, 16 June 1999).

[21] At the same time, it is assumed that each country makes important progress in its respective reform agenda, but could contribute towards greater harmonization of the respective macroeconomic situations and legislation, such as tax reform in Brazil; reform of the labor market in Argentina; or the on-going policies towards gradually reducing inflation in Uruguay.

[22] The figure is from Felipe de la Balze.

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Contents

MERCOSUR: The Incompatibilities between its Institutions and the Need to Complete the Customs Union. A Proposal Reform

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Summary

MERCOSUR faces difficulties in its efforts to remove non-tariff barriers, as well as differences in the area of incentives, since its institutional structure is incompatible with the aim of consolidating the Customs Union. In practice, the inter-governmental model, adopted because of an unwillingness to confront the "specter of supranationality", makes the bloc vulnerable to specific interests that condition the integration project. This is because the institutional model lacks a body with the exclusive function of preserving MERCOSUR's achievements and thus helping it to develop towards a Customs Union. Its existing bodies include only representatives of national governments, whose priority is firstly to their country and to national constituencies, and only secondly to the integration project. A debate on reforming the bloc's institutional design is therefore necessary, with particular emphasis on the question of supranationality and how to achieve this through gradual reform of the current inter-governmental scheme. In this respect there are grounds for optimism, since the members states have shown, by adopting a gradualist approach, their commitment to adapting the institutional profile to the needs of the project.

I. Introduction

The Southern Common Market (*Mercado Común del Sur*, MERCOSUR) is the most important and successful Latin American example of what has been termed "new integration" (Halperin [1992] p. 32).

This success has involved an integration process that combines significant advances in trade liberalization with the maintenance of trade barriers, and in which there are also asymmetries in terms of investment incentives. These problems pose a number of challenges for the scheme (Bouzas [1997] p. 66), since they have led to conflicts that have often remained unresolved. It is also important to highlight the link between trade and investment as an integral part of national and company strategies (Khaler [1995] p. 31).

These issues play a fundamental role in the process of consolidating the customs union, and are likely to have a similar impact on the common market. New issues are also

likely to come to the fore in future, such as the environment, labor relations, education, social questions, etc.

In order to confront the differences in non-tariff barriers and public policies that affect competition, the member states should make greater efforts to coordinate and harmonize their positions.

The aim of this study is to examine how successful the existing MERCOSUR institutions have been in tackling these problems. The institutional model will thus be analyzed and several suggestions presented.

This is not an easy task, since it has already been asked whether it is possible to speak of institutional and juridic requirements for a successful integration process (Best [1994] p. 12). The response here, as previously, is that it is possible if the study focuses on those instruments of the institutional model that aim to develop the scheme's agenda successfully.

II. Characteristics of MERCOSUR Institutions

MERCOSUR's institutional structure has been modified on a number of occasions since the *Treaty of Asunción*, the last of which were the reforms introduced by the *Protocol of Ouro Preto*. The design has always been inter-governmental, based on three decision-making bodies consisting of government representatives. It also includes two consultative bodies without decision-making powers (one consisting of parliamentarians, the other of entrepreneurs and trade unionists) and an administrative body. Policy-making and the management of the process are concentrated in three bodies with decision-making powers: the Common Market Council (*Consejo del Mercado Común*, CMC), the Common Market Group (*Grupo Mercado Común*, GMC) and the MERCOSUR Trade Commission (*Comisión del Comercio del MERCOSUR*, CCM). This study will focus on the nature of the institutional design of these three bodies.

Gradualism or Phobia Towards Institutional Development

In light of Argentina's and Brazil's experience of bilateral cooperation, MERCOSUR has opted to develop its institutions gradually. This is borne out by the number of institutions created, their characteristics and their powers. The quantitative dimension will be examined first, followed by the other characteristics.

In terms of the number of institutions, a gradualist approach implies that bodies are created as the need arises. This has given the institutional design process a transitory quality throughout its history. There is a desire to avoid the creation of unnecessary structures in a context of scarce resources. Hence, before an institution is created, a justification for its existence must be found and institutions should not therefore be created simply to tackle potential problems that might not in fact arise (Cohen [1993] p.9).

The bodies created are essentially political, since they consist of government-appointed officials who are not even named on a permanent basis. There is a shortage of purely technical institutions. The CCM, a body with political-technical characteristics, reflects these characteristics. MERCOSUR's Administrative Secretariat (*Secretaría Administrativa del MERCOSUR*, SAM) is the only permanent administrative body in the process, but it has little voice in its development.

In terms of the number of bodies created, this gradualism has proved to be both sensible (in that it has sought to avoid wastage), and coherent (in that it reflects the current view that is critical towards excessive institutional development). It has also been argued that MERCOSUR's growing importance creates a need to "bureaucratize" – in the best sense of the word – the project, through the creation of permanent administrative and technical support

structures that are capable of foreseeing and resolving problems. The gradualist approach might thus be seen as reflecting a phobia towards institutional development (Halperin [1992] p. 34), which is incapable of successfully tackling the demands of the project.[1]

The Incompatibility of the Inter-governmental Option

The process of developing closer economic ties between states is organized along various lines.

Integration processes that entail the creation of a common economic space are managed by a community body created for this purpose. Its members attribute powers to it that derive from their sovereignty. In other words, economic integration is accompanied by political integration.

There are also "traditional" cooperation processes in which each member maintains its economic and political individuality and the bodies created seek to facilitate inter-governmental collaboration on the administration of agreements. There is neither economic nor political integration.

MERCOSUR has opted for an inter-governmental institutional model to administer an economic integration project based on an incomplete customs union.[2] However, certain aspects of this model appear contradictory, since the aim is to administer an integration project with institutional mechanisms akin to cooperation. It is worth noting that this flaw is not only relevant at the theoretical level but also at the practical level, since integration – which is more complex than mere cooperation – demands institutions with more developed instruments. The aims of the process must therefore be simplified or the powers of the institutions increased (Halperin [1992] p. 32), (Jacque [1993] p. 21).

According to other authors (Khaler [1995] pp. 11, 81 and 117 and Grieco [1997] p. 171), there is nothing intrinsically wrong with MERCOSUR's decision to opt for an inter-governmental system since there are now other examples in the world where increased trade flows do not require greater institutionalization. The latter is only required when there is a need for cross-border policy harmonization. For these authors, this agreement is part of the "second wave" of regional processes, in which the actors rarely create significant supranational structures or develop collective decision-making mechanisms.

It is clear that, in practice, the states involved in such processes have maintained a certain coherence between the project and the institutional model underpinning it. The European Community (EC) is the most prominent example of the community model, while the Andean Group, despite its flaws, has also managed to maintain a certain level of coherence, at least formally. The North American Free Trade Agreement (NAFTA) and, in general, all free trade areas, have been coherent in that they have created institutions that are suitable for managing cooperation between member states.

According to the criteria highlighted above, such coherence does not exist in MERCOSUR. The member countries have corrected some of the distortions evident in the regional and sub-regional processes in which they had participated by adopting instrumental objectives compatible with the strategic goals of the project. However, they have not made the necessary adjustments in the institutional area.[3]

It has been claimed that the *Treaty of Asunción* carries a genetic code that could eventually determine MERCOSUR's future institutional development. The code is that of inter-governmental cooperation between states rather than a process of community management (Baptista [1996] p. 5). This "code" is also evident in all the regional processes in which the MERCOSUR members have participated. By opting for institutional gradualism, therefore, the members are perhaps expressing an unwillingness to confront the "specter of supranationalism". The image of this "specter" implies that integration schemes are

battlegrounds between national and community interests, in which one will prevail over the other (Halperin [1992] p. 37).

The Consequences of Incompatibility for Policy-formulation, Decision-making and Enforcement

The adoption of an inter-governmental model has had an important impact on the political process that has developed within MERCOSUR, and poses a difficulty for completing the Customs Union.

The system of inter-governmental cooperation has the following characteristics: 1) the bodies are made up of government representatives, 2) only the governments interact with each other, creating mutual rights and obligations through the application of norms, 3) the decisions adopted must be implemented by the governments. These characteristics are common to all inter-governmental schemes. However, MERCOSUR adds the following distinctive features: 4) norms are adopted by consensus in the presence of all member states, 5) responsibility for enforcement lies with the governments, 6) there is a dispute settlement process whereby the governments resolve their conflicts, 7) non-governmental actors have only a marginal formal role and, 8) there is a lack of technical bodies independent of the governments.

The make-up of the institutions is the main factor constraining progress in meeting MERCOSUR's objectives. The decision-making bodies are made up exclusively of government representatives who must ultimately act in accordance with the instructions they receive from their superiors. This means that the bodies in question are fundamentally political in nature.

Given the above characteristics, governments are the only key actors involved in the MERCOSUR process. They formulate policies, make decisions, oversee implementation and are responsible for appeals in case of a dispute. Sub-national governments, municipalities, businesses, workers, social pressure groups, etc., have only a very marginal formal role in these processes. These groups must depend on the patronage of their governments to assert their interests within the decision-making bodies.

These bodies are made up mostly of officials from certain areas of government, with priority being given to those from the economy and foreign ministries. The functions and "hierarchical" levels that make up each decision-making body also reflect a pyramidal structure, with the CMC at the top and the CCM at the bottom. This also partly reflects the hierarchical structures of the national administrations.

The CMC, the GMC and the CCM all have the power to initiate policies, adopt decisions and oversee implementation according to their areas of competence. These tasks are not specifically divided by issue area except for common trade policy, which is covered by the CCM. These bodies' responsibilities are thus shaped more by the hierarchy of the decision to be adopted rather than by its substance.

The model outlined above therefore conforms to a space composed of distinct hierarchical levels in which the public administrations of each country converge. This model favors horizontal interaction between national bureaucracies of the same hierarchical level, while those lower down the scale interact vertically with different levels, since their role is to provide support for those higher up the scale. The design is therefore political, and its characteristics will be examined below.

Inter-governmental interaction within MERCOSUR's bodies is initiated after each government has reconciled its own interests, and those of its nationals, with the common need to complete the Customs Union. Since the latter tends not to coincide with the former

it is often relegated to second place, depending on the strength and urgency with which the actor invokes a particular interest. This was a notable aspect of the conflicts that emerged in the first four months of 1997, particularly in terms of non-tariff barriers and public policies that affect competition. For example, Brazil sought to avoid external disequilibria in its economy by unilaterally imposing Provisional Measure 1569 in 1997, which set up new barriers to intra-MERCOSUR trade. This measure affected Brazil's partners, as well as progress in the integration process itself. The impact of specific private sector interests was also evident. These lobbied governments to maintain or dismantle trade barriers in disputes involving sectors such as pharmaceuticals, lubricants, leather, automobiles, foodstuffs and automobile investment subsidies.[4] Each government therefore invokes its particular interest when interacting in this common space. These interests are often incompatible with the policies needed to develop the customs union, and with the interests of other member states.[5] MERCOSUR's institutions are therefore bodies in which conflicts often arise and in which alliances are formed between an amalgam of particular interests, with measures to improve the customs union often relegated to second place.

The process described above has profound implications for the development of policies designed to establish a customs union.

When particular interests are dominant it becomes difficult to promote initiatives. There are blockages when officials "cannot see the wood for the trees", since responsibility for proposing measures to preserve and develop the customs union lie with individuals who depend on governments which, although they must examine the problems facing the project, have to respond in the final analysis to national interests.[6]

The difficulties of generating initiatives is also evident when decisions are adopted, since to eliminate the blockages the effectiveness of agreements must be weakened.[7] In many cases, states reserve wide powers to ignore some of the provisions in these agreements without suffering any consequences.[8] In these provisions, therefore, the declarative dominates over the operative. If this were not the case, it would prove impossible to make progress given the veto power of any one of the members. It must be noted that consensus is not the same as unanimity, since a member country can abstain but cannot vote against.

The impact of particular interests is also evident when states have to abide by what has been agreed – that is, if they have transposed the norm in question into domestic legislation, if it has been implemented, how it has been implemented, etc.[9]

An identical situation arises when states protest about non-compliance with an agreement. Under such circumstances, members exchange information and initiate a consultation process in the CCM. This consultation process reveals that all members have failed to honor certain aspects of the agreement, and have demanded compliance of others. This undermines the initial protests. On the other hand, agreements are broken because of a particular interest and compliance is demanded for similar reasons. There are no mechanisms to ensure compliance from a position independent of particular interests.

Successful integration processes tend to have an acceptable balance between their own needs and the particular interests of each member state. The European Community (EC) is an example of the above, since its institutional design promotes equilibrium and cooperative interaction between the two.

In MERCOSUR, all the policies and decisions adopted, their implementation and their enforcement, are dependent on the interests of each government. In such a context, the needs of the integration project often take second place. In this process there is a "genetic code" which impedes progress on the policy harmonization and coordination that MERCOSUR requires.

Another Consequence of Incompatibility: A Weakened Juridic Framework

Some authors, perhaps somewhat optimistically, have alluded to the concept of "Community Law" to describe MERCOSUR's juridic framework. An examination of the bloc's conventional norms and their implementation, however, reveals that such a term does not correspond to reality. This is because, as stated earlier, MERCOSUR is not a community of states but an inter-governmental cooperation scheme.

Community law cannot be implemented without the existence of a political and economic community with normative powers, in which multiple actors face both benefits and drawbacks (Sanguinetti [1994] p. 7). Community law and the community emerge simultaneously from the founding treaties that create them. Political integration and economic are thus linked by a key instrument, juridic integration.

The notion of a community has found its most forceful expression in the EC but, as outlined above, the differences between the European experience and MERCOSUR are great. In the latter, it is worth noting that the incompatibilities between the project and its institutional instruments also have an impact in the juridic sphere.

It is worth highlighting some of the characteristics of European Community law that have contributed to the establishment of a common market, as a means of seeing how the absence of such law in MERCOSUR has had an impact on the difficulties the bloc has faced in developing a Customs Union.

One of the first aspects of Community law worth noting relates to the Court of Justice of the European Community (CJEC). This body constitutes the "juridic order", despite attempts to view it as a set of norms. The fact that it is a juridic order provides the EC's legal system with a level of organization and a logic that enables it to introduce effective norms based on its deep and complex inter-relationship with domestic juridic systems (Mangas Martín and Liñán Nogueras [1996] p. 337).

This system is based on the founding treaties and its modifications, from which norms emerge that have an impact on EC member states. Prominent among the binding norms are general and mandatory rules, individual and mandatory decisions, and directives that are binding on members states but which allow the latter to choose the means of implementation. Additionally, some atypical acts, also binding, originate from EC bodies. The juridic order also includes external commitments assumed by the Community with third parties, and those treaties signed between its members on issues outside (but related to) the EC's area of competence. (Isaac [1995] p. 135 and Lasok and Bridge [1991] p. 112).

The effectiveness of the norms, backed by the existence of a juridic order, has been strengthened by the activities of the CJEC through the legal precedents that it has established with its rulings. This has led to the adoption of various important principles which have, in turn, increased the effectiveness of the juridic community. Three of these principles are particularly noteworthy.

The principle of "immediate applicability" implies that Community norms do not require domestic transposition – that is, from the moment a norm is approved it becomes part of national juridic orders. This principle applies both to the founding treaties and subsequent norms, including the directives, in which states have powers of "execution" but not of "reception". Community law thus comes into force with immediate, uniform and simultaneous effect in all member states.

The principle of "direct effect" was introduced to ensure that Community law is applicable in all states without the need for transposition. Individuals are therefore affected by it, in the sense that their domestic juridic rights are complemented by "Community" rights and obligations, be it in their relations with other individuals, with the Community,

or with the state to which they belong. This principle was established by the CJEC[10] on the basis of a systematic and teleological interpretation of the founding treaties. The rights and obligations which stem from a Community norm can be invoked before the administrative and judicial authorities, which have a duty to safeguard them. Not all norms have such an effect. To do so, the norms must include clear and precise obligations. The founding treaties and the regulations thus generate a direct effect, regardless of whether they are invoked by an individual against the administration or *vice versa* (vertical relationships) or between individuals (horizontal relationships). Decisions also have a direct effect. As regards directives, it can be concluded that, after numerous CJEC legal rulings, these also have a direct effect once the deadline has passed for a state to comply with its obligations. In such cases, individuals can appeal against the member state, but the state cannot appeal against individuals, nor the latter against each other (Mangas Martín and Liñán Nogueras [1996] p. 421, Hartley [1986] p. 185 and Moitinho de Almeida [1985] p. 61).

The principle of the "supremacy" of EC law over national law regulates relations between the Community's juridic order and the legislation of the member states. This principle, which was also established by the CJEC[11], states that if a Community norm is incompatible with a national norm, the former has primacy over the latter (Muñoz Machado [1986] p. 519), even when a national norm has been introduced after a Community one,[12] and even if the national norm is of a constitutional nature.[13]

These principles are supplemented by those determining a state's responsibility for failing to comply with Community law, ensuring that members cooperate to ensure its implementation, securing effective legal protection, allowing norms that are thought to run counter to Community law to be suspended, and those that ensure that the monopoly for controlling Community law lies with the CJEC.

For its part, MERCOSUR has a normative-based juridic order that is explicitly established in the *Protocol of Ouro Preto*. This sets out a hierarchy in which the *Treaty of Asunción* is the supreme "constitutional" norm linking all inferior norms.[14] The scheme is compatible with the inter-governmental nature of the process. The juridic order thus links the member states through norms that are binding on the governments. These norms only affect the governments. More precisely, they are directed towards the executive of each country, since in each of the four members it is the executive that has responsibility for foreign policy. Thereafter, depending on the issue in question, the norm is taken up by the body or authority with responsibility for transposing it or, in some cases, for undertaking the activity to which the government has committed itself. It can thus be deduced that MERCOSUR's juridic order links the member states, regulates their political commitments, and organizes their cooperation in the framework of the process.

The *Protocol of Ouro Preto* allowed that practice itself would define when a norm should be transposed. The member states have tended to signal the need for transposing most norms, and for the bodies responsible for carrying them through.[15] This is to some extent resolving the problem of when a norm can be considered to be in force in itself, or when it first needs to be transposed into national law (Sola [1996] p. 744).

Only when norms are transposed by the four member states do they transcend the government sphere and affect individuals. Hence the link between these individuals and MERCOSUR norms is only established once a domestic norm reproducing the MERCOSUR norm is approved. It is the national juridic authority that creates rights and obligations for individuals. This, however, is insufficient; it is also necessary for all member countries to transpose said norm according to the procedure set out in the *Protocol of Ouro Preto*.[16] As can be appreciated, the principle of direct effect does not exist as in Europe: the norms do not directly generate rights and obligations for individuals.[17]

Neither is the principle of immediate applicability of norms operating. On the contrary, the delays in transposing norms indicate that this principle is completely absent. These delays are caused by the lack of specific time-limits for honoring the obligations. The *Protocol of Ouro Preto* states that all the measures necessary for transposing MERCOSUR norms should be adopted, but does not set a deadline for compliance. The lack of a deadline weakens the binding nature of the norms. It takes two to three years to transpose a norm. This not only gives rise to a considerable time-lag between the issuing of the norm and its coming into force, but it also causes significant delays in implementing those policies agreed by the member states.[18]

The lack of a deadline lessens the likelihood that a member state will demand that another comply with what was agreed. It also exacerbates the lack of direct effect of MERCOSUR norms, since it dilutes the right of individuals to demand that their state protest about a recalcitrant member, or to protest against their own state in the competent national bodies if that state fails to abide by agreements made in an international treaty.

These problems are exacerbated by the lack of clarity in the *Treaty of Asunción* on whether it can override the national juridic order. This should be resolved in line with what was agreed in the *Vienna Convention*, which states that domestic laws cannot be invoked to renege on an international treaty.[19] However, it has been shown that this approach is essentially doctrinaire and that each state, on the basis of its sovereignty, can determine the hierarchy of a treaty in its internal juridic order (Paulo Pereira [1997] p. 35). The scheme is thus susceptible to the constitutional, legal and doctrinal asymmetries between members.

The asymmetries in the *Treaty of Asunción* regarding its primacy over national juridic orders are as follows. In Argentina, domestic legislation and treaties had equal hierarchy, with the former overriding the latter if these were approved later. However, a constitutional amendment in 1994 established the primacy of international norms over national laws, even if the latter were approved at a later date.[20] Paraguay employs the same criteria in its constitution. In these two countries, therefore, the *Treaty of Asuncion* can have primacy. In Brazil, however, according to its constitution and its legal system, a national norm can modify a pre-exiting international treaty. In Uruguay, although the issue has not been enshrined in law, in practice national law has primacy.[21] Identical asymmetries are obviously revealed by an examination of the hierarchy of MERCOSUR norms *vis-à-vis* national laws. It is also worth noting the inconsistencies of national courts when interpreting those national norms that stem from transposition.

These asymmetries erode the political commitments made at the inter-governmental level and undermine equality between the members. In a common system, the member states should have equal rights and obligations. This equality is guaranteed when all the actors are protected and regulated by a single juridic order. Although various sub-systems of norms can coexist, in the final analysis only one should prevail and this should be the same for all. The different reach that MERCOSUR's juridic order has in each country fragments it. This increases the "uncertainty" factor in the scheme, since some members can easily modify the norms while others cannot. As will be examined below, this situation is aggravated by the lack of a stable body that provides both a single interpretation and application of the law.

In sum, MERCOSUR's juridic order is based on the "inter-governmental" nature of the scheme. This helps the states to cooperate, but under no circumstances can the system be described as "communitarian". The inter-governmental system not only leads to inconsistencies with the bloc's aim of establishing a customs union, but is further weakened by the deficiencies outlined above, especially the absence of specific deadlines for transposing norms and the asymmetries between members with regard to the hierarchy of norms. The deliberate weakness of the juridic order reveals that in this case the states chose not to

submit themselves to rigid legal obligations that could restrict their maneuvering room to confront problems originating from both within and outside MERCOSUR.

The Dispute Settlement System and the Persistence of Conflicts

With respect to dispute settlement mechanisms, MERCOSUR has made more progress than other regional schemes in which its members are involved. The Latin American Free Trade Association (LAFTA) and the Latin American Integration Association (LAIA) only have a consultation mechanism for resolving conflicts. MERCOSUR, on the other hand, has established an arbitration mechanism.

This is undoubtedly a sign of progress, since to set rules and objectives without a "neutral" arbiter capable of resolving differences could weaken the scheme to the point of unviability. The mechanism includes a prior stage of diplomatic consultation under the auspices of the CCM, when a particular issue is within its sphere of competence. It is then discussed by the GMC. However, issues can be sent directly to the GMC for discussion. If no agreement is reached at the GMC, a state can activate the mechanisms to establish a court of arbitration, which would then rule on the issue. This decision would be binding for all parties.

As can be seen, a European-style supranational jurisdictional system has not been envisaged. On the contrary, MERCOSUR has opted for an *ad hoc* arbitration system, which is more akin to the institutional tradition of its members and with NAFTA (Dreyzin de Klor [1995] p. 1194). For their part, the national courts do not apply MERCOSUR law. They only invoke it indirectly via the national norm that has introduced it. The direct application of said law remains the exclusive responsibility of the national court.

The system described above is compatible with the inter-governmental nature of the process and its legal order, and therefore its only actors are the states. Individuals can only ask their national section to initiate the process, although in certain respects they can participate directly in it. While the system can fail to protect the individual should the section refuse to take up the issue, the individual can appeal the decision to the judicial bodies in his country. The state's obligation to individuals is an obligation "of means" but not "of results", since such bodies can move the process along according to the specified time-frames but do not have an obligation to guarantee a satisfactory outcome, unless a ruling against has been made on seriously erroneous technical grounds.

The lack of actors and bodies responsible for resolving disputes means that there is only one state-sponsored procedure – that is, the GMC and, eventually, the court of arbitration. There will be variations in this process depending on whether it has been initiated by individuals or by the CCM. The process takes a minimum of 243 days – if, as is highly unlikely, all the deadlines are met – and concludes with an arbitration ruling (Radresa and Fernandez Lemoine [1995] p. 1194).

The diplomatic negotiation stage involves governments, and an independent body is established only at the arbitration stage. The court has to rule on principles and dispositions of international law according to MERCOSUR's juridic norms. If the parties agree, the court can rule according to the principle of equity. The *ad hoc* nature of the court makes the drawing up of jurisprudence more difficult, since a new court must be established with each new case and precedent does not have to be respected. In the MERCOSUR system, therefore, similar issues can be resolved in different ways, thus further aggravating the flaws inherent in the juridic order. The limits of the system were evident in the court's first arbitration ruling (Gonzalez [1999] p. 1).

The possibility of appealing to equity can also be a good political solution for states, but a bad juridic solution for economic and social actors, since it can entail abandoning previously agreed rules.[22]

Although rulings are binding, however, and cannot be appealed, there is uncertainty over the extent to which a ruling is directly applicable in the country that has lost the arbitration. Some commentators argue that it is applicable, although others claim that a ruling must first be ratified by the Supreme Court of the country that lost the arbitration (Paulo Pereira [1997] p. 79). Regardless of which position is correct, the state that has won the arbitration can adopt retaliatory measures if the losing country fails to abide by the ruling. However, the binding character of the ruling is still weakened by uncertainty over its applicability.

An examination of the conflicts that have arisen shows that the member states, at this stage of the process, prefer the political aspects of the dispute settlement mechanism.[23] The governmental actors have channeled their differences through diplomatic negotiations in the CCM. When these have proved to be insufficient, they have resorted to higher-level political channels in which compromise and temporary solutions are generally adopted. It is undoubtedly positive that states exhaust all political channels to resolve their differences, but not all disputes can be resolved through this mechanism. Moreover, it is bad practice permanently to expose higher-level channels to the debilitating negotiating process, given the risks to the continued good functioning of the scheme that this implies. On the other hand, the system's preference for political solutions, without activating those which emanate from the norms, could undermine the juridic security of those affected by a crisis. It should be noted that, at the time of writing, only two arbitration rulings have been made in a process with numerous conflicts.

Moreover, MERCOSUR lacks a mechanism through which a single interpretation of laws can be provided when national courts have to apply them.

There are conflicts in MERCOSUR today because of difficulties in completing the Customs Union and the existence of a dispute settlement mechanism that is unable to resolve differences definitively. The costs of coordination failures have therefore become apparent (Yarbrough and Yarbrough [1997], and should spur modifications that make the mechanism more effective.

III. Some Points for the Debate

Taking into account the demands and difficulties of MERCOSUR, as outlined above, this section examines a number of points that should be included in the debates on a possible institutional reform of the bloc. The aim is to demystify some "taboo" issues and to examine certain criteria that could be developed on the basis of the model currently in force. These issues will be presented with broad brushstrokes.

The Specter of Supranationality

As noted above, MERCOSUR has been inconsistent in adopting the objectives of an integration process while designing institutional instruments that are more compatible with a model of inter-state cooperation.

In integration processes, members tend to cede responsibility for managing the scheme, via what is known as "supranationality", to a community body that has powers compatible with the aims of the scheme. Such a model includes institutional cores that orient common progress while the member states, in line with their needs, intervene in the decision-making process to set the pace of integration and to lower the costs of an excessive "acceleration". The members thus seek a balance between particular interests of the actors involved and the needs of the scheme.

It is true that conflicts between community interests and those of individual states have arisen in these models. In many cases, the former tends to prevail over the latter. This has raised the "specter of supranationality" in the public mind; community interests are seen as

imposing themselves on national interests, with a consequent loss of sovereignty. This perception has prompted conflicts in integration processes. The European case can perhaps serve as a paradigm: denunciations of the "injustices and abuses of the Brussels bureaucracy" have been common, although, paradoxically, the powers given to Community bodies by the member states have been increasing. In MERCOSUR the decision to adopt an inter-governmental cooperation model is in part a response to the fear of the "specter of supranationality".

To what extent, therefore, is the Southern Cone justified in fearing the loss of sovereignty that would allegedly result from adopting a communitarian model? The answer can perhaps be found by first examining the experience of the European Union (EU) in this respect.

According to some commentators, the Community has developed institutionally by reflecting the existing tensions between the supranational aspirations of the *Treaty of Rome* and the inter-governmental concerns of many of its members. In this context, the member states have transferred powers to a sphere where sovereignties are "pooled". This has had profound implications for the traditional role of the state in Western Europe, since the process implies organizing the continent along federal lines. However, the member states still have a predominant role and, in fact, the "pooling" of sovereignties increases rather than reduces the power of individual states (Holland [1992] pp. 90 and 114).

On the other hand, it has also been argued that the EU is making progress towards creating a federal system in which the Community bodies have powers over the internal and external sovereignty of national states, and that the treaties have evolved from multilateral agreements to accords that can be defined as quasi-federal constitutional norms (Mancini [1991] p. 178). This view has been criticized by other commentators. These argue that, although the bodies created appear more powerful than the classic international organizations, they are also weaker with respect to national states, especially since the Community is built on the basis of national political systems. Its weaknesses, therefore, stem from the difficulty of forcing its component parts to abide by agreements. This would not be possible in a federal system.

As can be appreciated, this debate illustrates the difficulty of defining the type of traditional model of political organization that best corresponds to the Community. According to the critics of the classical federal model, the Community is best defined as a confederation, since its main institutions are clearly inter-governmental and entail the establishment of common structures compatible with high degrees of diversity. However, the notion of a confederation cannot be applied to all its activities, especially with respect to the negotiations carried out within it (Kehoane and Hoffman [1992] p. 278).

New explanations are therefore necessary to help define the Community experience. It has been noted that there is in the Community an amalgam of national systems within a new common scheme, with its own powers, institutions and procedures. The model is thus a combination of federation and inter-governmentalism. As such, it is a system that can be defined as almost "cooperative federalist", in which more and greater common powers result in more and greater interference on the part of national bureaucracies (Wessels [1991] p. 149). This system is based on the sovereignty of national states that always have the option of withdrawing from the scheme (Williams [1991] p. 158).

The Community is therefore organized as a network, based more on a grouping and an association than on the transfer of sovereignty. The common bodies and the national states interact within it, although the latter always have the final say on key issues (Kehoane y Hoffman [1992] p. 278). Progress on common objectives was made possible by this interaction between national and Community actors, based on a balance of powers between the supranational and the inter-governmental which emerged from its institutional design.

Most analysis on this issue therefore rejects the view that there is a "loss of sovereignty" that would imply adopting a supranational management scheme for integration projects. Supranational systems are models of management rather than of transfer of sovereignty. Sovereignty is not transferred to the supranational entity. Rather, an association of these powers is administered by central bodies, but the member states have the final say. States preserve their sovereignty in this way, and by being able to withdraw from the project. Hence there is an interaction between the whole and the parts that make it up, in order to make progress towards a defined end. Although in some respects this type of model does imply a loss of autonomy for individual governments, this stems more from the integration project agreed to than from the management system. If a state is committed to coordinating policies within this type of scheme, it is this decision that reduces the national maneuvering room.

The fear surrounding the loss of sovereignty from supranationality is therefore unjustified. Nevertheless, it is also true that although "specters" do not exist, they cause fear.

It is therefore essential that the fears surrounding this management model are dispelled in MERCOSUR. It is worth noting that the bloc's members have never participated in a system with these characteristics. Hence the need to make gradual progress in a direction that is conducive to spurring changes in the political culture of the institutional actors and the citizens of each country.

The European Community opted for this management model after the shocks induced in the peoples and leaders of the continent by the consequences of the war. This decision was in turn backed by a tradition that supported the notion of a Europe united in a federation of states. While it is true that there is a pro-integration tradition in Latin America, there is also a history of mutual distrust and an absence of shocks of the magnitude of the Second World War that could have brought about a political decision in favor of supranationality.

To the changes outlined above one should add, among others, the reform of the Brazilian and Uruguayan constitutions to allow powers to be transferred to common bodies. The project and its legislative activities would otherwise be subject to the uncertainty associated with persistent judicial challenges.

Some Criteria for Institutional Reform

As regards the possibility of making gradual progress towards the establishment of a management model with supranational characteristics, MERCOSUR could modify its current model to enable it to develop into a community scheme, thereby overcoming some of the problems associated with the inter-governmental design.

On the basis of the inter-governmental model, criteria are presented below which could promote the development of institutional mechanisms that facilitate those activities associated with the customs union and the common market. However, areas not included in that agenda are not examined, since they are not part of this study. Also excluded are issues relating to the democratic deficit in MERCOSUR's institutions, the scant participation of the various regions and sub-national states, and the lack of formal representation for economic and social actors in the process. Problems associated with the relative power disparities between the members are also excluded from the analysis. Given the importance of these issues, they deserve to be examined separately in other studies.

Reforming and strengthening the institutions. Developing a context that promotes the integration project

The earlier examination of the current problems facing the customs union noted that one of the factors impeding its completion was the institutional model's susceptibility

to the national interests of the bloc's members. These interests affect policy-making, decision-making, policy implementation and dispute settlement, since only governments are involved in these processes.

It is worth making clear that governments act in this way because of the need to satisfy the concrete sectoral demands of interest groups, so as to resolve problems that could otherwise undermine governability, etc. If governments were to ignore these demands they could suffer a loss of internal power and, to some extent, they would be failing to honor their primary mission of responding to the demands of their citizens. In an inter-governmental system, this type of behavior is normal and generally understandable.

The needs of the integration project can be more abstract. The costs of non-compliance first affect the other members of the scheme and only then can they have an impact on the transgressor country. How it affects the latter depends on the relative power disparities between members.

The problem is that what is normal in inter-state cooperation projects is not appropriate for integration schemes, since the latter require high levels of coordination where there is little room for non-compliance.

It is therefore necessary for MERCOSUR to establish bodies specifically to develop policies that are conducive to the completion of the Customs Union. How can such a mechanism be introduced in an inter-state cooperation system? The answer lies in moderating the inter-governmental bias of the present institutional structure by setting up an independent body with the exclusive function of promoting policies to improve the Customs Union.

To guarantee the independence of this body, the officials that constitute it should not depend on nor receive instructions from the governments of the member states, but should be MERCOSUR functionaries. The safeguards established by those blocs that have adopted this system should also be incorporated. This body should also be permanent, reflecting MERCOSUR's importance as a bloc. It should have technical functions, since this is an area in which MERCOSUR is weak.

A related issue is the lack of a voice that can "represent" MERCOSUR independently of the needs of each member state. The *Treaty of Asunción* introduced rules of the game that are worth examining, since it raised the expectations of both citizens and economic actors. The technical role of such a body should therefore be to promote projects that contribute to meeting the agreed objectives. Attention should also be paid to the introduction of mechanisms to protect the agreements when there is a need to address situations that are traumatic for the particular interests of specific actors.

This type of body could, for example, facilitate agreement on issues such as non-tariff barriers, public policies that affect competition, the classification of policies that are compatible or not with the Customs Union, and on the best way to eliminate or harmonize such policies. These issues would then be discussed in an environment free from the pressure of specific interests.

In its technical role, it could also have the power to oversee the implementation of policy, recommend modifications and offer technical advice and information so that the members can adopt decisions.

The creation of such an independent body would be a first step towards resolving some of the problems of the project, even with the limitations of the inter-governmental management model.

To avoid a proliferation of bodies, and to create a mechanism as outlined above, an independent body could be set up by reforming the Trade Commission. The Commission fulfils all the requirements, since it is the most technical body in the political process. The

CCM could therefore continue to assist the GMC, but independently of governments and with purely technical functions in proposing initiatives and in following up policies.

In such circumstances, the GMC's role would also have to be redefined. The GMC is the bloc's non-permanent inter-governmental executive body, which has the peculiar characteristic of having decreed numerous norms executing the policies presented by the Common Market Council. Given the characteristics of the model suggested here, and the new role that the CCM would adopt, it makes little sense to maintain the GMC as a purely executive body since most of its executive functions, especially those associated with policy-making and oversight, would be absorbed by the Commission. Without losing its executive function, the GMC could therefore boost its decision-making capacity on issues requiring a lower level of political responsibility. The GMC should continue to consist of government representatives. Its members should also be permanent appointments and, together with the CCM, be exclusively dedicated to administering the integration project on a day-to-day basis.

The SAM could become part of the GMC to provide support functions.

The CMC should remain the highest decision-making body but with a small, permanent administrative support.

Designing a political process that balances the needs of the project with specific interests.

As shown above, the political process is dominated by actors that fundamentally defend specific interests. The idea of introducing into this system an actor with exclusive responsibility for developing common objectives also demands that a political structure be created in which there is an interaction between its bodies when formulating initiatives and making decisions. The balance required would not otherwise be achieved.

Given its technical role, the body responsible for promoting the common project should therefore have a predominant role in drawing up initiatives. When a particular issue remains unresolved within the process, it would formulate the necessary proposals to resolve it and thus avoid future difficulties.

This is not to say that it should concentrate exclusively on initiating policy within the scheme, since it is always positive that other actors have that function. Before an initiative is adopted, the independent body and the member states should debate the issue. This would enable the former to take public opinion into consideration and moderate some of the more conflictive aspects of the proposal, while the latter could gain a better understanding of the benefits of the proposal and thus reconsider any possible objection to it.

It is also true, however, that when a decision is to be made on an initiative, one view has to prevail, otherwise the proposal would remain blocked by interminable discussions. Particular interests predominate in the decision-making process. However, if there is to be a relatively balanced level of interaction, exclusive responsibility for decision-making will have to rest with the independent body. Any debate that takes place prior to making a decision would be based on the specific needs of the integration process.

Since all integration processes are based on the sovereignty of the member states, the final decision on a specific issue will rest with these. The decision-making process of the model under consideration would therefore be nuanced by the specific interests of each state, and the norms would be adopted either in the CMC or in the GMC, depending on the level of the norm, and on whether responsibilities have been delegated, etc. Under these circumstances, national interests will prevail but within pre-established parameters that will function in support of the common project.

After a proposal has been adopted and prior to making a final decision, a mechanism should be introduced that would enable the independent body and those responsible for norms to interact and thus resolve any pending problems that had not been overcome prior to the formulation of the proposal. The member states, however, would still have the final say and would determine the pace of progress towards meeting the project's objectives.

In this respect, the GMC's decision-making functions, its permanence and its exclusive role should be strengthened. It would thus serve as the true executive body and as a link between CCM proposals and government directives by bringing closer together the various diverging opinions and thereby enabling progress to be made on resolving current and future problems. Obviously, when defining a norm, the GMC should act according to instructions from the governments.

This process would create a system in which the body responsible for promoting a common project can interact with those primarily responsible for serving specific interests. This mechanism would have a part to play both at the proposal stage and the decision-making phase of the process.

Specific interests and MERCOSUR's power asymmetries will continue to prevail. However, limiting discussion within parameters that will benefit the development of the Customs Union can help reduce such disequilibria, since the state that fails to comply will bear the costs of a failure of coordination. At present, this cost is difficult to quantify since there is no mechanism to decide whether a particular policy decision is "good" or "bad".

Strengthening the system of norms

As regards the system of norms, the problems associated with its failure to create a juridic order were outlined above. These problems are evident in its lack of primacy over the systems of national norms, the lack of direct effectiveness, immediate applicability, etc. A weak system of norms makes non-compliance easier. It can thus be concluded that, in designing a system with such characteristics, the member states opted to retain some political maneuvering room to counter the reach of the accords.

However, it is also the case that such a situation leads to uncertainty in the rules of the game that economic actors must follow when taking important trade and investment decisions in a highly risky and unpredictable environment. In order to create a stable environment, therefore, it is necessary to strengthen MERCOSUR's juridic order to make its norms more effective and to allow the member states to retain some maneuvering room.

It is therefore necessary that the scheme's norms have primacy over national norms, so that the commitments agreed to cannot be weakened by subsequently approved national legal dispositions. A clause to this effect should be introduced through an additional protocol to the founding treaty. An identical clause should also be included in the constitutions of those members that have not yet done so, thereby preventing such primacy from being revoked by the judicial system in each member state. In a customs union, a formal body of law for all cannot function if in practice it produces disparities when members opt to apply laws in different ways.

As regards the lack of immediate applicability and the difficulties arising from delays in transposition, these problems could partly be resolved by fixing deadlines before which member states must comply with a particular request. If it fails to do so, the other member states could activate the dispute settlement mechanism. By fixing a deadline, the states could also win some time to resolve the dispute.

The fixing of deadlines also helps to reduce the problems associated with the lack of direct effect of the norms, since in setting a specific time-limit that allows the non-compliance of a member state to be identified, the ensuing objection of a particular member state can be strengthened. At this particular point, the former will be forced to respond to certain rights and obligations, while the latter will be able to demand, through its legal system, compensation for damages arising from the other's non-compliance.

Dispute settlement

It has been noted that MERCOSUR suffered a series of trade-related conflicts that were only resolved through temporary agreements based on political commitments that often bypassed the treaties. These agreements were often negotiated at the presidential level, highlighting the difficulty of finding solutions at levels lower down the hierarchy and exposing the bloc's highest authorities to the debilitating effects of the negotiation process. This study also noted how these conflicts persisted, and that the mechanism envisaged in the *Protocol of Brasilia* was unable to resolve them.

In general, there is a need to involve lower-ranking officials in efforts to resolve disputes. It would also be advisable to strengthen the legal framework underpinning the dispute settlement process, by streamlining its procedures and involving the independent body and individual citizens.

Individuals could participate by asking their own country (or another member state, if its interests are affected) to sponsor them. In this context, attention should be paid to the international system's structures for resolving disputes involving investment protection.

A round of consultations between the states in dispute should therefore take place first. If the dispute cannot be resolved at this stage, the independent body could intervene by submitting a compromise proposal based on the common interest and on agreed norms to help resolve the conflict via political means. An initiative to resolve the dispute could thus emerge without the risk of it being vetoed prior to its formulation.

If such a proposal were to be rejected because of opposition from one of the members in contention, the states would be able to resort to arbitration. In such a case, it would be preferable to have a permanent court that would allow the development of a "jurisprudence". It would also therefore be advisable to establish a system that would limit rulings based on equity, since this would motivate the member states to resolve conflicts based on that criterion during the prior political negotiation stage, for fear of entering into an irreversible process in which norms would be strictly applied.

The strength of the rulings applied by the Court of Arbitration must also be taken into account. As stated earlier, irrespective of what the *Treaty of Asunción* says about the binding nature of these decisions, they should be directly applied by a state without the national juridical authorities first having to transpose them into domestic law. This would enhance the authority of these rulings while preserving the rights of those negatively affected by a state's non-compliance, as well as the right of the state that has won the arbitration to adopt policies that compensate it for the transgressor's non-compliance.

The Court of Arbitration should also issue opinions on how MERCOSUR law is to be interpreted by the national courts that apply the rulings. It would thus be necessary to examine whether member states need to reform their constitutions or whether a modification to their procedural norms would be sufficient. There might also be need to increase judicial cooperation mechanisms between the courts of member countries, so as to harmonize criteria for interpreting the founding treaty and its related norms.

IV. CONCLUSIONS

This study has indicated how, in practice, MERCOSUR has found it difficult to develop the characteristics typical of a Customs Union.

This failure is partly due to the pressure exercised by the specific interests of various actors which, because of the inter-governmental institutional model, have managed to block the development of initiatives, decision-making and measures to enforce policies that seek to improve the scheme. MERCOSUR is thus affected by the problems that stem from the decision of its members to create an integration project based on an institutional model more akin to an inter-state cooperation scheme.

The article subsequently highlighted the need to establish an institutional integration structure, noting that this does not imply that members lose their sovereignty. To that end, the study presented a number of criteria which, while derived from inter-state cooperation, could help adapt the institutions to make them more effective for the purposes of completing the Customs Union.

Will the member states move in such a direction? An answer is obviously impossible, since it lies in the realm of futurology. However, the members of the scheme have shown signs that they are prepared to adapt the institutions to the needs of the process.

Notes

[1] During the conflicts with Brazil in the first third of this year, the Argentine Business Council asked Argentine President Carlos Menem to set up an informal body to help settle disputes. The president responded by stating that this would create more bureaucracy and fewer solutions (See Argentina's *Clarín* newspaper 15/4/97 p. 24).

[2] MERCOSUR is often referred to as an integration project since it seeks to create a common market on the basis of a common external tariff that is implicit in a Customs Union. Tariff preference areas, free trade zones and other similar schemes, however, are projects of inter-state cooperation, since the different custom areas do not form part of a single territory. The various projects analyzed at the start of this study show how these are clearly incompatible.

[3] Both the Latin American Free Trade Association (LAFTA) and the Latin American Integration Association (LAIA) claimed that their strategic objective is the creation of a common market. However, their instrumental objectives have not been not compatible with this aim, since they hope to achieve it through a free trade area or tariff preference schemes. Because of MERCOSUR's greater commitment to integration, this incompatibility was offset by its decision to set up a customs union, which is the first step towards creating a common market. LAFTA and LAIA are administered by an inter-governmental scheme that is compatible with its instrumental objective. Although MERCOSUR resolved the question of the incompatibility of its instrumental objective, its institutions have not been reformed accordingly.

[4] An article in *Clarín* (26/2/97 p. 2,) states that "it is the interests of the pharmaceutical companies, both Argentine and Brazilian, that carry weight here". See also p. 23, which states that in the foodstuff sector, the head of COPAL was to meet the ambassador in Brazil to pressure the government of that country (see also *Clarín* 29/4/97, pp. 20-21). The tariff conflict in the paper sector was also resolved through an agreement involving these same actors INTAL, ([1997] p. 25). Similar pressure was exerted by interests representing Brazil's north-eastern states, the province of Buenos Aires and the Toyota company involving automobile investment subsidies (see *Clarín* 7/3/97 pp. 18-19).

[5] In the conflicts mentioned in the previous note, the members states reacted in a predictable manner defending their own interests and those of their nationals.

[6] For example, in the case of public policies that distort competition there were serious difficulties in terms of making progress in the classification of measures because of the different positions adopted by the member states. Non-tariff measures and barriers faced similar difficulties. The difficulties that emerged during these earlier stages made it harder to promote initiatives that could resolve such problems.

[7] For example, in the case of the financial measure restricting Brazilian imports from the other member states, the conflict was resolved by an agreement that softened its impact on these countries but that still kept the restrictions in place, contrary to the agreements setting up the customs union. The solution, however is temporary.

[8] For example, see CMC Dec. 6/93 Annex B Arts. (3) and (4 b) by which the parties reversed the obligation to provide information on sanctions relating to sanitary measures.

[9] The delays in transposing Res. GMC 23/95 on the introduction of a pharmaceutical register and the subsequent appeals were caused, as noted earlier, by the Brazilian and Argentine laboratories, respectively.

[10] "Van Gend En Loss" case 05/02/1963.

[11] "Costa vs. Enel" case 15/07/1964.

[12] "Simenthal" ruling 09/03/1978.

[13] 1965 "San Michele" ruling that specifically mentioned this normative element, despite what was implicitly alluded to in "Costa c/ Enel" cit.

[14] *Protocol of Ouro Preto* Art. 41.

[15] See, for example, GMC Res 22/94.

[16] *Protocol of Ouro Preto* Arts. 38 to 40 inclusive.

[17] In the consultations in the CCM, both the defendant and the plaintiff are represented by states; individuals do not participate in the process.

[18] For example, in Res. GMC 48/93 on packaging and 86/93 on determining residual monomers, there were delays of up to three years. Delays in transposing GMC 23/95 on a pharmaceutical register and Res. 45/96 on wines led to conflicts in the first third of 1997.

[19] Vienna Convention on Treaties Art. 27.

[20] "Ekmedjian vs. Sofovich" ruling by the Supreme Court of Justice.

[21] In Brazil, ruling on Extraordinary Rec. 80,004, of 1977, Brasilia's Supreme Federal Tribunal.

[22] In practice, various juridic orders coexist in a single space. This flaw could have been partly corrected by the creation of a permanent court that would have the final say on interpreting and applying law based on consistent criteria. If the rulings emanating from such a court are also based on equity, then the value of the imperatives contained in these norms is further enhanced.

[23] This type of phenomenon has also been typical in the integration process in Europe, where litigation between states is very rare since the Community bodies and individuals have opted for this mechanism.

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Electronic Commerce in the Americas

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Summary

The Internet is used by growing numbers of users globally to enter into commercial transactions. The available data shows electronic commerce has been growing rapidly in the Americas, with significant gains made in the number of hosts registered in countries of South America and the Caribbean, and rapidly growing numbers of users. However, obstacles remain for electronic commerce to reach its full potential in the Americas. In Latin America, in addition to regulatory issues that may slow down the development of electronic commerce, the physical infrastructure poses a significant barrier to the future growth of the Internet. In order to create the appropriate environment for electronic commerce growth, governments must ensure that the physical infrastructure and the regulatory framework are adequate to support this growth, without imposing new and unnecessary burdens on businesses and consumers. This paper looks at the recent growth of Internet use in the Americas, and at some of the factors that may inhibit the more rapid development of electronic commerce in the region. It then provides an overview of the initiatives that some governments have adopted in order to foster the growth of Internet use and electronic commerce. Finally, the article identifies some of the challenges and opportunities that governments and the private sector in the region face with respect to this new mode of conducting business.

I. Introduction

At present, global Internet revenues are estimated at US$ 100 billion, of which about 70 percent represents business-to-business electronic commerce and the remaining 30 percent represents the more recent development of business-to-consumer electronic commerce. Global electronic commerce is expected to continue its exponential climb and could approach a staggering US$ 1.3 trillion by 2003.[1]

Predictions of explosive growth in electronic commerce anticipate a marked increase in the number of Web users in countries around the world, as electronic commerce is carried out over open networks such as the Internet. While the United States presently leads the world in Internet use and electronic commerce by a wide margin, this is changing. Over the next three to five years, the number of Internet users worldwide is forecast to jump from 201 million in 1999 to 345 million. Judging from current trends, analysts expect that over the same period, over half of all Internet users in 2005 will speak a language other than English, with comparable gains made in the posting of non-English content.

In Latin America, the recent growth of Internet use and electronic commerce has been among the most rapid in the world. The total number of registered Internet hosts reached 502,526 in January 1999 for Latin America and the Caribbean, representing an increase of 102 percent over the previous year. This increase showed itself to be particularly striking in terms of improving the ratio of Internet hosts per inhabitant, which dropped by nearly one-half over the year, from 1770 to 887 inhabitants.[2] In the eleven largest Latin American economies the number of Internet hosts increased at an annual rate of 144 percent between 1993 and 1997. In North America, the number of hosts had reached over 3 million by January 1999. In terms of the total number of users in the hemisphere, according to Jupiter Communications, Latin America at present accounts for only about 5 percent of the worldwide online population (equivalent to around 5.3 million users). Different estimates place this figure in the year 2003 at anywhere from 20 to 34 million users (or approximately 10 percent of the total online population at that time), though this type of growth is difficult to predict accurately.

Spending on electronic commerce in Latin America reached nearly US$ 167 million in 1998, an increase of 361% over 1997 levels. According to an International Data Corporation (IDC) study, these figures include both business-to-consumer and business-to-business e-commerce transactions. IDC expects the region to have an above-average compound annual growth rate (CAGR) of 117% between 1998 and 2003 and to surpass the US$ 8 billion mark in spending by the end of 2003.[3] Of the total value of online purchases, Boston Consulting Group estimates that consumer spending in domestic online retail sites is expected to reach an estimated US$ 77 million in 1999. As barriers to the growth of e-commerce continue to fall, this market could grow as high as US$ 3.8 billion by 2003.[4] Within Latin America, Brazil dominates the current e-commerce market, representing 88 per cent of all Latin American-based online sales. Mexico has the second largest market with six per cent of sales with Argentina accounting for just two per cent.

II. Internet and Electronic Commerce in the Americas

The state of development of the Internet market in the Americas

Internet use and its growth over the recent period in countries of the Americas are dependent on a number of factors. Some of these factors include, among others: per capita income; level of education; access to computers; cost of Internet connection and use time; the structure and competitiveness of the domestic telecommunications market; the state of development of telecommunications infrastructure; and the regulatory framework for telecommunications and electronic commercial transactions.

Table 1 summarizes the most salient indicators with respect to the Internet "readiness" in ten countries of the Americas under the three main categories of general Internet connectivity, telecommunications infrastructure and use, and economic indicators. The ten countries selected for this study are as follows: Argentina, Brazil, Canada, Chile, Colombia, Costa Rica, Mexico, Peru, United States and Venezuela. These countries constitute a representative sample as the largest Internet users in the hemisphere. Data on all relevant indicators are therefore more readily available for these countries.

The information in the table shows that Internet use is highest in those countries where the density of telephone use is greater, where the provision of telecommunications services is more competitive (for example, as shown by a larger number of local and international telephony service providers, a larger number of Internet service providers operating on the domestic market, as well as lower average cost of local and international telephone use), and where the combined costs required to access and use the Internet are lower (as discussed in relation to Table 3).

As illustrated by the information in Table 1, there is a great deal of disparity at present between countries of the Americas with respect to the state of development of infrastructure (provision and access to telephone lines), and computer use by the general population. For example, the number of personal computers per 100 inhabitants varies from around 5 in Latin America to 27 in Canada and 40 in the United States. The provision of Internet access and other related services, such as web hosting and web design, has been expanding rapidly in the period since the mid-1990s. The liberalization of telecommunications services in some countries of the region has also spurred competition in the Internet service provider (ISP) market, creating a dynamic environment and leading to lower costs of access for both business and residential users.

Equally striking is the significant difference between countries in terms of the number of Internet users. In the United States, for example, 40 percent of households own a personal computer, and in Canada and the U.S. around one-third of the population uses the Internet on a regular basis. This can be contrasted with Latin American countries, where Internet use at present is current only among 1 to 1.5 percent of the population.

Another indication of Internet use is the number of hosts in national markets, or those operators that set up a presence on the Internet through a web page. Surveys of hosts are the most common indicator used to measure Internet development. They are undertaken for all countries of the world by Network Wizards, and published on a semi-annual basis. Network Wizards define an Internet host as a domain name that has an associated IP (Internet protocol) address, and its surveys include all country code Top Level Domains and generic Top Level Domains. Information on the number and growth of Internet hosts in countries of the Americas over the period January 1997-January 1999 has been compiled from this source and is presented in Table 2.

This table again underscores the great diversity at present in the spread of Internet use throughout the Americas. While in Canada and the United States over one and a half million hosts were registered as of January 1999, with a continued growth of around 50 percent in new hosts, the largest number of hosts in Latin America was registered in Brazil (quarter million). Other than Mexico, Argentina, and Chile, fewer than 20,000 hosts were registered in all other countries of the Hemisphere. In the Caribbean, outside of Trinidad and Tobago, less than 500 hosts were registered in each country, with fewer than 100 in eight countries. A few countries of the Hemisphere have experienced very high rates of growth for Internet hosts (of over 200 percent), while others have actually lost hosts over the two-year period.

Costs of Internet access in the Americas

Several factors representing fixed and variable costs influence the ability of consumers to use computers and Internet services at present in the Americas. Table 3 sets out information on such costs, compared with average annual per capita income. From this table, it is apparent that the use of computers and Internet services is primarily available to the upper income groups of society in Latin America and the Caribbean. The average price of a personal computer may be estimated at between US$ 1,000 - US$ 1,500. This represents as much as one-half of the per capita annual income of the average citizen (or six months of earnings) in many countries, as compared to the wealthier countries in the Hemisphere where the same average price of a computer represents around one-twelfth or less of the per capita annual income of the average citizen (or one month of earnings). The cost of a personal computer represents approximately one-half of average per capita income in Colombia, Costa Rica and Peru, or six months of earnings, and one-third of per capita income in Brazil, Chile, Mexico, and Venezuela.

Purchase cost is not the only factor in influencing the ease of Internet use. The monthly cost of Internet access must be added to the cost of equipment and connection. This ranges widely in the Hemisphere, from US$ 12 in Peru to more than US$ 50 in Venezuela. On average this cost is about US$ 20 - US$ 25, in both North America and Latin America. The average price of a monthly untimed Internet access subscription for a business in Latin America is around US$ 35, but the rates vary tremendously even within countries. Information on countries other than the ones cited in the comparative table points to a range of monthly Internet access cost as follows: Bahamas, US$ 65; Bolivia, US$ 19; Belize, US$ 20; Ecuador, US$ 45; Honduras, US$ 39; Suriname, US$ 18; and Uruguay, US$ 30.[6]

In addition to these costs, a monthly subscription charge for telephone service must be included. This cost varies as well, ranging from around US$ 3 in Brazil, Colombia and Venezuela, to around US$ 15 in Chile (for residential users). The cost of telephone subscription for businesses is usually higher, often twice the amount of residential rates. Besides the fixed monthly costs of Internet access and telephone subscription, the telecommunications operators in many countries of the Hemisphere levy additional variable charges on use of telephone lines, on a per minute basis. The slower the Internet connection is, the higher will be the charges for the user, varying depending on the time used by the user to browse or complete a transaction online. Speed of Internet connection is in turn a function of the efficiency of the telecommunications infrastructure, particularly the bandwidth for access, and the amount of information that can be carried across the network at any point in time. The total cost to the user is therefore a combination of both the fixed and variable components discussed above, and tends to be considerably higher on an average per capita income basis in Latin America and the Caribbean.

For businesses, additional costs are necessary in order to use the Internet for commercial purposes and to gain a presence "on line". While the cost of registration of a domain name is very similar across all countries in the Americas, ranging from US$ 50 in most to US$ 100 (with this a free service in Canada), the average cost of design for a web page is dependent upon the technology used for this purpose and varies widely across countries (from US$ 20 to US$ 4,000). Additionally, a commercial web page requires annual expenditures for maintenance and updating which can be substantial, particularly for small and medium-sized businesses.

In part due to the costs described above, electronic commerce transactions are still in the early stages of development in Latin America and the Caribbean. Currently, Internet technologies appear to be used primarily by corporate Latin America for purposes of marketing and internal communication rather than for commercial transactions. Firms deriving income primarily from electronic commerce are still rare in the region, although this is changing for certain large firms. The unavailability of online payment facilities and the relatively low penetration of credit cards among the general population in much of Latin America means that most Latin American consumers use the Internet at present for information collection purposes but conduct their business offline. Estimates of the value of electronic commerce in national markets are scarce. As occasionally reported in the media, this type of business reached around US$ 6 million in Chile and US$ 39 million in Mexico in 1998, figures which can be compared with US$ 5.5 billion in Canada and US$ 8 billion in the United States.

III. Government Initiatives to Foster the Growth of Internet Use and E-Commerce

Several governments in the Americas have adopted wide-ranging initiatives and programs to promote the growth of Internet use and electronic commerce, while many others have these under consideration. Government programs designed to expand access

to basic telephony and Internet services, and to facilitate use of the Internet and electronic commerce both within government agencies and for individuals in dealing with government agencies are currently being implemented in a number of countries in the Americas.

Many of these initiatives and programs pertain to telecommunications services. Several governments in the region have also adopted the concept of "universal service" as defined in the WTO Reference Paper on Basic Telecommunications as the basis of their telecommunications policy, whose objective is to provide telecom services to all consumers, especially those in rural and remote communities through the use and adoption of various technologies. Governments are attempting to implement this concept both through legislative requirements and regulatory reform. Other government telecom programs have as their aim the introduction of competition in local, long distance, and international markets for telephony, and the improvement of the quality and diversity of telecom services.

Programs to guarantee interconnection and interoperability with global information technology networks are underway in several countries. Internet access is being promoted not only on an individual basis through the use of personal computers, but also through community-based centers such as public libraries, schools, and adult community centers. Programs to increase public access to the Internet have been started by governments in Argentina, Canada, Chile, Peru, and the United States, while the Mexican government has defined objectives in this area.

Initiatives and programs to make available government services through electronic means are an important part of public policy objectives in countries of the Americas so that governments can lead the way as "model users" of the Internet and electronic commerce. Access to government services via electronic means is still very much in the early stages in the Americas. At a minimum, individuals in most countries in the region are able to access government agencies by e-mail as well as via the Internet. The conduct of certain transactions through electronic means is already possible in several countries where consumers and businesses may pay income taxes and customs duties, and may obtain export/import licenses electronically. In some countries consumers may access social security accounts and pension fund accounts in this manner, while other countries have instituted electronic means for the purpose of public bidding and procurement.

Governments in the region are actively promoting their role as model users and appliers of information technology. In Argentina a bill is under consideration to create a National Intranet Service. The Government of Canada has indicated that electronic commerce will become the preferred means to conduct its business, and a range of projects has been set in motion for this purpose. Public bidding and procurement already take place electronically. A comprehensive policy framework for Internet and electronic commerce is set out in *The Canadian Electronic Commerce Strategy* (*http://e-com.ic.gc.ca/english/ecom_eng.pdf*).

The Government of Mexico has developed an Electronic System for Government Contracting (COMPRANET) that includes information on the federal government bidding process and allows users to make inquiries and download applications for any public bidding process over the Internet. Also in Mexico, an EDI Committee has been created as a joint partnership between public entities, business organizations, banks and educational institutions, to promote the electronic exchange of data between companies through the development and implementation of standards to facilitate exchange of commercial information and test projects for the promotion of electronic billing.

In the United States several government agencies carry out the administration of records and the disbursement of government benefits electronically through partnerships between federal and state government agencies and the private sector, and some government agencies conduct their procurement activities via the Internet. Venezuela has

programs underway to interconnect government offices and agencies through information technology, while proposed legislation to promote Internet use and electronic commerce is under consideration in Argentina, Chile, Colombia, and Mexico.

Governments are still grappling, however, with a host of new issues raised by the proliferation of electronic transactions. These issues include recognition of digital signatures and electronic documents, protection of intellectual property, the protection of privacy, consumer protection, taxes and tariff collection, among others. The central question in many cases is whether there is a role for governments to intervene and regulate, or whether market forces should be allowed to make the necessary adaptations to the electronic environment. Certain countries have opted for a mixed approach (for example, Canada and the U.S. with respect to the promotion of electronic commerce, the protection of privacy and intellectual property rights). In Latin America, most countries have yet to define an approach towards governance of many electronic commerce-related issues. The situation may prove particularly complicated in many Latin American countries whose legal tradition requires paper-based documents and signatures, and the notarization of key documents. Such requirements might make companies unable or unwilling to use electronic contracts in business transactions.

Nevertheless, recent legislative activity in some countries indicates that governments are making significant efforts to remove uncertainties that might inhibit the willingness of companies to engage in electronic commerce. Governments have either enacted legislation or presented draft legislation or guidelines to begin the process of addressing the issues mentioned above. For example, Colombia passed an Electronic Commerce Law in August, 1999, which explicitly accords electronic documents and signatures the same legal recognition as paper documents. The Colombian law also sets up the regulatory structures for the issuance of digital certificates that link users to their signatures. Draft legislation on the use of digital signatures was presented to the Argentine Congress in August, 1999. In Chile, Ecuador, Peru, and Brazil draft laws on electronic signatures are also pending. Mexico has proposed modifications to its commercial code with the purpose of removing existing obstacles to electronic commerce. Significantly, all of these legislative attempts use as their basis the Model Law on Electronic Commerce developed at the United Nations Center for International Trade Law (UNCITRAL) with few if any modifications as their basis, thus ensuring some level of harmonization between countries.

IV. Opportunities of Electronic Commerce for Countries in the Americas

The above developments suggest that electronic commerce holds tremendous potential for expanding trade throughout the Americas and for increasing the region's competitiveness in international markets. Underscoring this potential is the fact that for the last few years Latin America has led the world in the addition of new Internet users. User growth in Latin America led the world with a total of 5.3 million users in 1999 and an estimated 20 million users or more by 2003. Spending on electronic commerce in Latin America, estimated at US$ 170 million in 1998, is predicted to increase by over 175 percent to reach current U.S. spending levels on electronic commerce by 2003, or around US$ 8 billion.[6]

Improved access to the region's markets is at the heart of the Free Trade Area of the Americas initiative, begun in December 1994 by the Heads of State of countries in the Americas. Electronic commerce will make it possible to access each other's markets at very minimal costs. The most immediate commercial gains from the expansion of electronic commerce are likely to be in business-to-business electronic commerce, especially in the banking/financial services and manufacturing sectors.

Throughout the Hemisphere, the use of electronic commerce should allow companies to enjoy higher growth and improved economic efficiency and profitability.

Resulting productivity gains should propel the economies of FTAA members and lead to a higher standard of living for the region's citizens.

The dividends should be especially high for the region's smaller companies and smaller economies that traditionally have been hampered by limited information, high market entry costs and distance from markets. The use of electronic commerce by small and medium-sized enterprises means the elimination of traditional barriers to trade such as the distance between markets and the difference in size between firms. It offers an inexpensive means of soliciting bids, receiving orders, purchasing goods, and tracking sales, in a way that allows small and medium-sized enterprises to reduce overheads and administrative costs and presents them with the opportunity of broadening their operations.

Smaller economies are positioned to benefit greatly from the advent of the Internet and electronic commerce, as these provide the opportunity for their firms to access global audiences at much lower costs and to thus penetrate international markets. Governments in smaller economies benefit from the electronic and low-cost dissemination of information and knowledge throughout their territories. The development of electronic commerce and the advantages provided by its use generate investment opportunities in the public and private sectors in the areas of technology, application, training, and infrastructure development.

For governments, the use of information technologies in economic transactions generates administrative and productive efficiency through cost reductions for both the public and the private sectors. For consumers, online purchases will continue to grow, and will allow opportunities for unprecedented choice without geographical limits, increased convenience and access to creative content for goods and services. Many "web stores" can more easily customize their products to suit particular individual preferences or needs, providing an unparalleled level of personalized service.

Electronic commerce can make an important contribution to future sustainable economic growth in the Americas. The expansion of electronic commerce throughout the region can also play a positive role in hastening the Hemisphere's integration into a unified, regional market. Whether or not electronic commerce furthers these objectives will depend in large part on the trade and regulatory environment that the region's governments adopt toward this innovative medium.

V. Challenges for Countries in the Americas

In order for the development of electronic commerce to be fostered in the Americas, policy makers, businesses and consumers need to identify the obstacles that could constrain the growth of this type of trade and take steps towards overcoming such barriers. Electronic commerce in Latin America is disadvantaged at present by language barriers, expensive and unreliable shipping, the low use of credit cards, and consumer distrust of the medium. Therefore firms in Latin America and the Caribbean face several challenges in their attempt to develop electronic commerce activities. In several countries of the Hemisphere online payment facilities are not yet available and when they are, credit card payments are not authorized without a physical signature. Consumers remain highly skeptical of the security of online payment systems. Thus issues of payment security and consumer protection need to be addressed, and countries of the Hemisphere that wish to participate in electronic commerce will need as a first step to undertake the legislative reforms necessary to enable the recognition of electronic contracts and signatures.

Like traditional commerce, electronic commerce requires substantial infrastructure, a legal framework, and market access. These areas represent priority challenges for the Hemisphere. With regard to infrastructure, potential users in many countries of the region confront access limitations to telecommunications networks, along with high prices and

user costs. Government policies to promote electronic commerce through the provision of open, competitive markets will require widening access to telecommunications services at more affordable prices and increasing the availability of telecom equipment at international prices. Barriers in the form of low quality of telecommunications infrastructure, narrow bandwidth, and high connection costs are presently slowing the spread of electronic commerce in many countries in the region.

In addition to the improvement of physical infrastructure, the expansion of Internet use and electronic commerce will depend upon the development of skills, or human resources. Much of the formal electronic commerce skills development in Latin America appears to be provided by Internet service providers rather than by universities or public technical support institutions, a gap which needs to be addressed. The promotion of computer literacy may also be fostered by governments implementing programs to act as «model users» of the electronic medium.

With regard to the legal framework, the Internet poses challenges to governments seeking to understand and regulate the emerging issues inherent in a global, interactive and fast-paced new technology. Development of an appropriate regulatory environment covering issues such as authentication, encryption, and electronic signatures, privacy and consumer protection, enforcement of contracts, and the protection of intellectual property is critical to the expansion of Internet use and electronic commerce. With regard to market access, the avoidance of new barriers to electronic commerce would be served by avoiding the imposition of customs duties on electronic transmissions.

In the fiscal area, the governments of Latin America and the Caribbean are facing significant challenges related to the taxation of electronic commerce transactions. Taking into consideration the expected growth of electronic commerce in the region, governments would be encouraged to begin analyzing the potential effects that could be observed with regard to tax revenues.

In adjusting to the new modes of communication and trading provided by the use of information technology, and given the above considerations, the major challenges before the governments of the Americas appear to be those related to infrastructure development, the development of an appropriate legal framework, building trust for consumer and business use of electronic commerce, and development of skills and awareness.

The main challenges that countries in the Americas face as they prepare to increase their participation in the Internet-driven economy thus can be summarized within the following four categories:

Challenges relating to infrastructure development

- Developing physical telecommunications infrastructure.
- Providing universal access at reasonable cost to a reliable telecommunications infrastructure in all countries of the Hemisphere.
- Achieving the interconnection and interoperability of all telecommunications networks and services.

Challenges relating to the development of an appropriate legal framework

- Adapting national juridical and regulatory systems with a view to examining whether electronic commerce issues are covered by existing laws and

regulations, or whether there is a need to introduce changes in order to accommodate the validity of electronic transmissions and transactions.

- Generating a context of public policies that maximize the benefits of electronic commerce without compromising the legitimate objectives of public policy.
- Developing approaches for recognition and certification of electronic signatures, taking into account the level of technological development and the different legal systems of the FTAA countries.
- Protecting intellectual property through guaranteeing protection of copyright and trademarks in the electronic environment.
- Understanding the tax implications of the new information technologies and offering the same tax treatment for electronic commerce as for conventional commercial activities; designing technological solutions that facilitate tax administration and compliance with tax obligations.
- Ensuring the validity and enforcement of electronic contracts and providing consumers and firms with effective means for determining jurisdiction and having recourse to dispute settlement.

Challenges relating to building trust for consumers and businesses

- Developing and establishing an atmosphere of confidence for the user of electronic commerce that will not allow discrimination as between electronic and traditional trading methods.
- Establishing reliable, secure, and accessible electronic payment systems.
- Protecting user privacy in electronic commerce operations, without generating unnecessary barriers to trade.
- Ensuring an adequate protection of the consumer against practices such as deceptive advertising, fraud, unlawful content, etc. and guaranteeing the same degree of consumer protection for commercial operations through the Internet as for those by conventional means.
- Fostering coordination between businesses in an effort to efficiently integrate productive chains through the use of electronic commerce.

Challenges relating to the development of skills and awareness

- Supporting and encouraging the development of human resources, including through the training of information technology professionals, with appropriate information technology skills.
- Supporting small- and medium-sized enterprises in adopting new technologies to reduce the cost of access to electronic commerce that will enable them to achieve greater efficiency and competitiveness in the global marketplace.
- Stimulating the use of electronic commerce between private individuals and firms based on use by governments.
- Increasing efficiency and transparency in the civil services and in the supply of public goods and services by use of the Internet.
- Increasing efficiency in the acquisition of goods and services by public entities.

Table 1

Summary of Most Salient Indicators Relevant to Internet "Readiness" in Selected Countries in the Americas

	Argentina	Brazil	Canada	Chile	Colombia	Costa Rica	Mexico	Peru	U.S.A	Venezuela
General Internet Connectivity										
Population (millions)	35.7	163.7	30.3	14.6	40	3.5	94.3	24.4	267.6	22.8
Internet users (thousands)	250	2,350	12,700	150	350	50	713	65	106,000	80
Internet users as percentage of total population	0.65	1.4	42	1	1	5.8	0.7	0.26	39.7	3.3
PCs/ 100 inhabitants	3.9	2.63	27.1	5.4	3.3	—	3.73	1.23	40.67	3.66
Internet hosts/10,000 population (Jan. 1999)	18.28	12.88	364.25	20.18	3.93	9.20	11.64	1.91	1,131.52	3.37
Telecommunications indicators										
Main phone lines/ 1,000 inhabitants	191	107	609	180	148	169	96	68	644	116
Main lines/100 inhabitants	17.38	9.57	60.24	15.59	11.76	15.47	9.48	5.99	63.99	11.74
Monopoly (M) versus competitive (C) local telephony service provision	C	C	C	C	C	M	C	M	C	M
Phone service monthly subscription charge (business) (US$)	34.6	9.4	37.7	21.8	3.0	7.7	13.7	16.4	41.8	18.3
Phone service monthly subscription charge (residential) (US$)	8.7	2.7	13.2	15.3	3.0	5.3	6.3	8.9	12.2	3.2
Cost of a 3-minute local call (US$)	0.09	0.09	0.00	—	0.01	0.04	0.14	0.09	0.09	0.07
Average monthly cost of online Internet access (US$)	41.90	26.96	—	40.27	35.56	40.00	26.10	12.75	—	54.35
Mobile phones/ 1,000 inhabitants	56	28	139	28	35	19	18	18	206	46
Economic and Social Indicators										
GNP/capita	8,970	4,570	20,020	4,810	2,600	2,780	3,970	2,460	29,340	3,500

Sources: World Bank, 1999 World Development Indicators; World Bank, World Development Report 1999/2000; Various sources, from NUA Surveys, "How Many On-Line?" (http://www.nua.ie/surveys/how_many_online/s_america.html); ITU, World Telecommunication Development Report: Universal Access, World Telecommunications Indicators, 1998; Inter-American Biodiversity Information Network (IABIN), Internet Topology and Connectivity in the Americas, 1999.

Table 2

Growth of Internet Hosts in Countries of the Americas

	Domain Names	Hosts Jan. 1997	Hosts Jan.1998	Hosts July 1998	Hosts Jan. 1999	Avg. Growth Jan. 98 Jan. 99	Population (thousands)
Latin America							
Argentina	ar	12,688	20,924	59,010	68,978	230%	34,194
Bolivia	bo	30	554	506	632	24%	7,237
Brazil	br	77,148	122,814	174,596	224,916	83%	159,128
Chile	cl	15,885	18,771	23,820	31,083	65%	13,994
Colombia	co	9,054	10,397	12,069	16,322	57%	36,330
Costa Rica	cr	2,555	2,979	2,879	3,357	13%	3,304
Dom Rep.	do	2,301	4,853	4,917	4,851	-.04%	8,100
Ecuador	ec	590	1,056	1,237	1,566	5%	11,227
El Salvador	sv	132	196	653	820	318%	5,635
Guatemala	gt	274	668	1,052	913	37%	10,322
Honduras	hn	52	74	110	102	38%	5,750
Mexico	mx	9,764	49,764	92,467	120,967	143%	88,543
Nicaragua	ni	531	515	698	723	40%	4,156
Panama	pa	751	1,029	780	760	-26%	2,612
Paraguay	py	187	365	930	1,157	217%	4,788
Peru	pe	3,192	3,544	3,830	5,118	44%	23,238
Uruguay	uy	1,823	10,338	16,444	16,823	63%	3,163
Venezuela	ve	2,417	4,134	7,093	8,189	98%	21,177
North America							
Canada	ca	603,325	1,000,468	1,229,088	1,584,273	58%	29,248
United States	us	587,175	1,137,066	1,372,109	1,642,148	44%	160,650
Caribbean							
Antigua	ag	169	183	196	179	-2%	67
Bahamas	bs	195	215	247	485	126%	284
Barbados	bb	21	23	45	72	213%	263
Belize	bz	12	257	262	254	-1%	223
Dominica	dm	55	76	79	148	95%	73.5
Grenada	gd	0	1	2	3	200%	98.6
Guyana	gy	52	67	58	70	5%	843
Haiti	ht	0	0	0	0	0	7,300
Jamaica	jm	249	266	253	327	23%	2,500
St. Kitts	kn	2	5	1	5	0	43.5
St. Lucia	lc	21	14	24	23	64%	147.2
St. Vincent	vc	0	0	0	0	0	110.7
Suriname	sr	4	1	0	0	0	411.5
TrTobago	tt	141	919	1,531	1,994	117%	1,300

Source: Network Wizards, *Internet Domain Survey*, 1999 at http://www.nw.com

Table 3

COMPARISON OF THE FIXED AND VARIABLE COSTS OF INTERNET USE IN SELECTED COUNTRIES OF THE AMERICAS

	Monthly cost of Internet access [a]	Telephone monthly subscription [b]	Cost of local call (US$ per 3 minutes) [c]	Per capita income 1998 [d]
Argentina	41.90	8.7	0.10	8,970
Brazil	26.96	2.7	0.09	4,570
Canada	—	13.2	0.00	20,020
Chile	40.27	15.3	—	4,810
Colombia	35.56	2.9	0.01	2,600
Costa Rica	40.00	5.3	0.04	2,780
Mexico	26.10	6.3	0.14	3,970
Peru	12.75	8.9	0.09	2,460
United States	—	12.2	0.09	29,340
Venezuela	54.35	3.2	0.07	3,500

Sources: [a] IABIN, Internet Topology and Connectivity in the Americas, April 1999: http://www.iabin.org/document/internet/report.htm; [b] ITU, World Telecommunication Development Report, 1998 (data are for 1996); [c] World Bank, 1999 World Development Indicators (data are for 1997); [d] Banco Mundial, World Development Report 1999/2000 (GNP *per capita* for 1998).

Appendix

Electronic Commerce in the FTAA process

Establishment of the FTAA Joint Government-Private Sector Committee of Experts on Electronic Commerce was set out in the San José Ministerial Declaration of March 1998 (paragraph 19), and subsequently endorsed by Heads of State in the Santiago Summit Declaration of April 1998, at the time of the official launching of the FTAA negotiations. The status of the Committee is that of a non-negotiating body, with a unique composition drawn from both public officials and private sector experts in the area of electronic commerce. Membership in the Committee is open to all FTAA governments. Private-sector experts in the Committee are identified by government representatives on the basis of their expertise in the issues considered, and with a view to establishing balanced geographical representation.

In San José, Ministers set up the Joint Committee with a view "to increase and broaden the benefits to be derived from the electronic marketplace".[7] The Committee was asked to prepare recommendations to this end and to present them to ministers at their meeting in Toronto in November, 1999. From September 1998, to November, 1999, the Committee met five times under the chairmanship of Barbados. The work of the group of experts dealt with twenty-six issues of relevance to the functioning of electronic commerce in the Americas, including user issues, the legal and commercial framework for electronic commerce, business facilitation issues, and issues affecting small and medium enterprises and smaller economies.[8] The Committee has begun coordinating its work with, and aims to keep itself appraised of, efforts under way in other international fora whose work is concerned with establishing multilateral rules that govern the growing use of electronic commerce, such as the World Trade Organization (WTO), the World Intellectual Property Organisation (WIPO), UNCITRAL, the newly created Internet Corporation for Assigned of Names and Numbers (ICANN), and APEC.

At the Trade Ministerial Meeting in Toronto on 3-4 November 1999, the Committee presented a report of its first year of activities, containing recommendations to Ministers on the issue-areas that the Committee explored during the year. Ministers welcomed the report and renewed the Committee's mandate for the next period of negotiations, until April 2001 when Ministers will meet again in Argentina to review the progress made in the FTAA process. Ministers also agreed to share the report with other «relevant authorities» within their respective governments, as well as with the public at large.[9] The Committee maintains its non-negotiating status, and is again expected to make recommendations to Ministers in Argentina in accordance with its mandate.

In conclusion, the Internet offers users in the Americas the opportunity of conducting business via a medium that is inherently global by its nature and recognizes no borders. Some collective agreements or standards will be necessary in order to derive maximum benefit from this new trading vehicle, and private entities should, where possible, take the lead in organizing them. In those instances where government regulation is necessary, it should be internationally coordinated to avoid having incompatible national rules fragment regional and global markets. Appropriate spheres for government action might be envisaged in such areas as protection of consumers (including aspects of personal data privacy), development of appropriate tax policies, protection of intellectual property, combating fraud, enforcement of the sanctity of contracts, and raising citizens' skills and awareness.

Notes

[1] *ActivMedia*, 1999.

[2] Network Wizards, *Internet Domain Survey*, 1999.

[3] International Data Corporation (IDC), *1999 Latin America Internet and eCommerce Strategies*.

[4] Boston Consulting Group (BCG), Latin America Report, 1999.

[5] Inter-American Biodiversity Information Network, *Internet Topology and Connectivity in the Americas*, 1999; for information on the methodology used to obtain these average cost figures see web site: www.iabin.org/document/internet/sur-isps.

[6] International Data Corporation, *1999 Latin America Internet and eCommerce Strategies*.

[7] Ministerial Declaration of San José, San José, Costa Rica, March 19, 1998, para. 19.

[8] The papers presented by the Chair as background material for the Committee's work are posted on the FTAA official website at *http://www.ftaa-alca.org/spcomm/note_ece.asp.*

[9] Declaration of Ministers, Fifth Ministerial Meeting, Toronto, Nov. 4, 1999, para. 27.

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The Institute for the Integration of Latin America and the Caribbean (INTAL) was created by an agreement between the Inter-American Development Bank (IDB) and the Government of Argentina in 1964. Institutionally, INTAL is part of the Integration and Regional Programs Department of the IDB.

For more than 30 years INTAL has been actively involved in research activities, technical cooperations for governments and institutions in the academic and business field, and training in support of the integration and regional cooperation processes. As of 1996, the Institute working plan is based upon a new conceptual and operational strategy which meets the demands and changes produced in the regional integration scenario in Latin America and the Caribbean, as well as a response to the strong tendency towards the globalization of the economies which came about in the latest years around the world. Based upon this, INTAL has implemented four lines on action:

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