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**Lessons from NAFTA
for Latin America and the Caribbean**

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Lessons from NAFTA for Latin America and the Caribbean

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Lessons from NAFTA for LCR countries

Executive Summary

The Free Trade Area of the Americas (FTAA) is closer to becoming a reality, with potentially major effects on the flows of goods and capital across the Western Hemisphere and significant consequences for growth and development in the region. This report aims to provide guidance to LCR countries on what they can expect from the FTAA, and to identify policy steps -- both in terms of measures that countries can take unilaterally and those that could be negotiated with FTA partners -- that can help them derive the maximum benefits from trade integration in the Americas.

Mexico's performance under NAFTA provides the most directly relevant experiment from which other LCR countries can learn about the likely contents and economic effects of a trade agreement with the U.S. For this reason, the report draws extensively from the NAFTA experience. However, attempting to draw lessons from NAFTA for the FTAA poses several difficulties. First, only a short time has elapsed since implementation of the agreement, and Mexico's post-NAFTA years started with the dramatic setback of the Tequila crisis in 1995, making it hard to disentangle the effects of the treaty on the Mexican economy. Second, an FTAA might differ from NAFTA in major respects, and thus their results could also be different in important dimensions. Third, there is considerable diversity in the initial conditions of LAC countries hoping to join the FTAA, and hence the key priorities, necessary preparatory measures and likely effects of accession also differ considerably across countries.

In these respects, the report is selective rather than exhaustive. While it devotes attention to a few key issues regarding possible content changes between NAFTA and the FTAA, and considers how specific characteristics of FTAA prospective members may shape its impact, it does not attempt to cover the full range of alternatives of FTAA design and/or member countries' initial conditions. Nor does it intend to identify the particular set of policies best suited for each individual country in Latin America and the Caribbean; instead, it underscores those reform areas where the experience of NAFTA suggests that policy action in preparation of, or conjunction with, the FTAA will have the biggest payoff in terms of growth and development. A companion report on "Deepening NAFTA" draws policy lessons for Mexico.

The report's main conclusion regarding NAFTA is that the treaty has helped Mexico get closer to the levels of development of its NAFTA partners. It has had salutary impacts on trade, foreign direct investment (FDI), technological transfer, and growth. It can probably take some credit for moderate declines in poverty, and has likely had positive impacts on the number and quality of jobs. However, NAFTA does not suffice to ensure economic convergence among North American countries. This reflects both limitations of NAFTA's design and, more importantly, pending reforms in Mexico's policy agenda.

An FTAA designed along the lines of NAFTA will offer new opportunities for growth and development in LAC, particularly if improvement is achieved on some of the most negative aspects of NAFTA – such as the distorting rules of origin and the anti-dumping and countervailing duties. However, significant policy and institutional reforms will be necessary in most countries to seize those opportunities. In particular, the reforms will need to focus on reducing macroeconomic instability, improving the investment climate and the institutional framework, and putting in place an education and innovation system capable of fostering technological advancement and productivity growth. In addition, regional trade integration will have to be accompanied by unilateral, bilateral and multilateral actions on other trade fronts to maximize the gains from trade liberalization and reduce the possible costs from trade diversion caused by the FTAA.

These conclusions follow from careful analysis of a comprehensive, although not exhaustive, set of issues associated with the implementation of NAFTA and the upcoming FTAA. To identify the effects of NAFTA on Mexico and other countries – especially the neighboring countries of Central America and the Caribbean -- the analytical work reviewed policies and trends prior to and after NAFTA implementation, using in many cases a broader international perspective and drawing lessons from the experience of other FTAs, notably the EEC / EU.

The report consists of seven chapters. Chapter 1 examines the evidence concerning economic convergence in North America by assessing how NAFTA has affected Mexico's per capita income relative to the U.S. Chapter 2 studies the evolution of macroeconomic synchronization across NAFTA member countries, sectors and regions, and draws the relevant implications for macroeconomic policy design. Chapter 3 provides a critical evaluation of NAFTA's remaining trade barriers by focusing on the impact of rules of origin on trade in manufactures, especially textiles and apparel, agricultural policies, and anti-dumping and countervailing duties. Chapter 4 focuses on the integration of factor markets, namely capital and labor. Chapter 5 provides a comprehensive diagnosis of Mexico's innovation system. Chapter 6 examines the consequences of NAFTA for the trade flows of third countries, and Chapter 7 does the same with FDI flows to countries excluded from NAFTA. Both chapters pay particular attention to NAFTA's neighbors in Central America and the Caribbean. This summary discusses the report's main findings and policy recommendations.

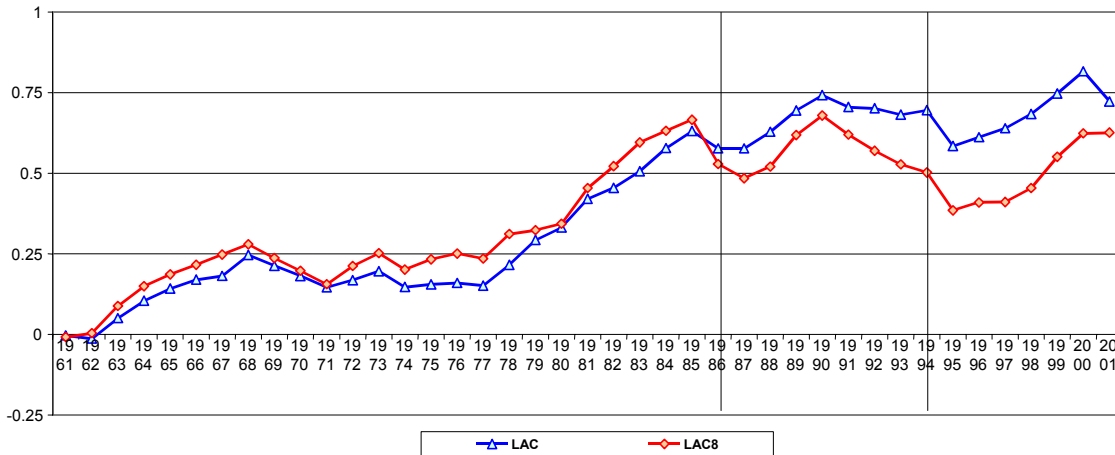
1. The FTAA and economic convergence in the light of NAFTA

NAFTA has brought significant economic and social benefits to the Mexican economy. Trade, FDI and growth outcomes improved as a consequence of NAFTA and Mexico's earlier unilateral reforms initiated in the mid 1980s. Real wages have recovered rapidly from the 1995 collapse, and the poverty rate has followed a similar path.

Yet one key conclusion from careful evaluation of the impact of NAFTA is that the treaty does not suffice to ensure economic convergence in North America. Mexico still suffers from important gaps that constrain its ability to catch up with its Northern neighbors. The statistical evidence (Chapter 1) shows that unilateral trade reforms and

NAFTA helped Mexico enter into a process of economic convergence with respect to the U.S., and after 1995 the gap between its Gross Domestic Product (GDP) per capita and that of the U.S. has evolved more favorably than in other Latin American and Caribbean economies (Figure 1).

Figure 1. Trends in per capita GDP : Mexico - U.S. Differential relative to LAC - U.S. Differential, 1961-2001



Note: The dependent variable is the log of GDP per capita (ppp adjusted) over the U.S. GDP per capita. Each annual effect is the difference between a Mexico year effect and the average LAC year effect. The comparator groups were the following: LAC 8 = Argentina, Brazil, Chile, Colombia, Costa Rica, Peru, Uruguay, and Venezuela. LAC = 22 Latin American and Caribbean countries. The omitted year was 1960.

However, the process of convergence faces significant constraints that drive a wedge between per capita GDP in Mexico and the U.S. even in the long run. The report concludes that the key constraints result from institutional gaps (Chapter 1) and deficiencies in education and innovation policies (Chapter 5). In fact, the gap in the quality of the institutional framework is the biggest single factor behind the income gap between the two countries (Figure 2). While the per capita income differential is also affected by a number of other factors, taken together they actually contribute to offset in part the large income gap attributable to Mexico’s institutional weaknesses relative to its partners. Moreover, for the rest of Latin America and the Caribbean the situation is very similar: the institutional gap emerges as the biggest obstacle to the region’s income convergence with the U.S., a conclusion that puts in perspective the benefits to be expected from the FTAA.

Institutional reforms, especially those aimed to improve the rule of law and fight corruption, will be critical for the future economic development of the Region. They will help narrow the current institutional gaps with respect to the U.S., which for many LAC countries (with Chile as the main exception) remain substantial, in spite of the fact that most of them, including Mexico, and especially Chile and Central America, did make some progress in the 1990s regarding the quality of their institutions (Table 1).

The experience of Mexico also indicates that institutional improvements should not be expected to be automatic byproducts of North-South free trade agreements.

Substantial unilateral efforts will be required to revamp Latin American and Caribbean institutions and speed up income convergence in the Americas. The role of education and innovation policies is discussed further below.

Figure 2. Mexico: Estimated Impact of the Institutional Gap on the per capita GDP Gap

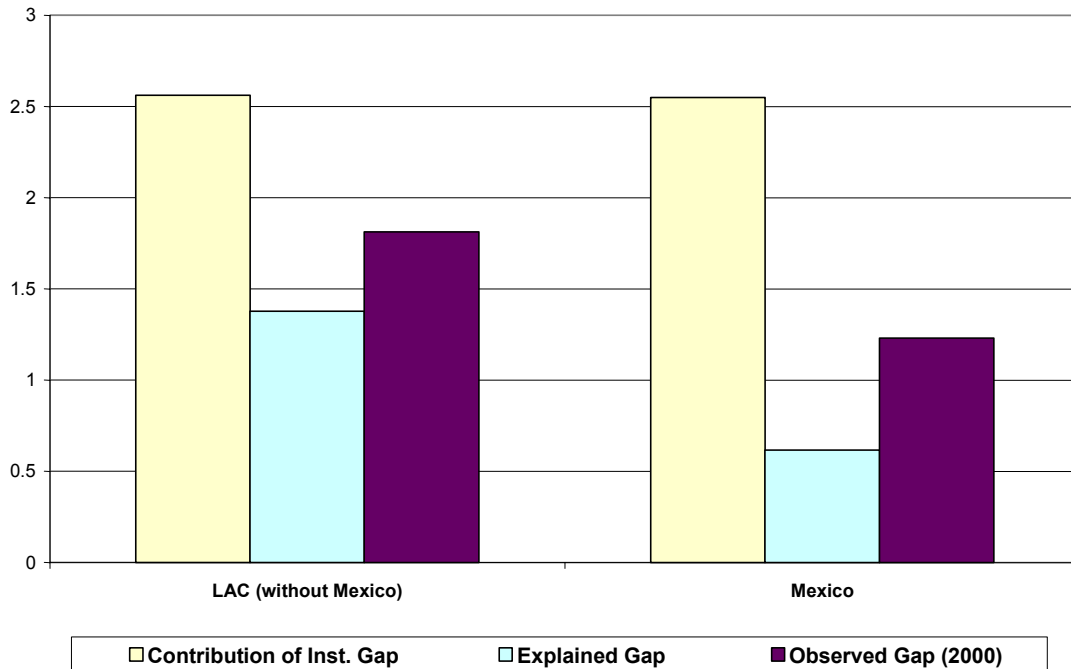


Table 1. Mexico and Latin America: Institutional Changes

Country / Group	Before-NAFTA 1984-1993	After-NAFTA 1994-2001	Change After-Before
Mexico	-1.80	-1.46	0.34
Argentina	-1.49	-1.05	0.43
Brazil	-1.00	-1.57	-0.57
Chile	-1.55	-0.73	0.82
Colombia	-1.80	-1.91	-0.11
South America	-1.68	-1.59	0.09
Central America	-2.51	-1.61	0.90
Andean Countries	-1.98	-1.60	0.39
Latin American Countries	-1.83	-1.53	0.30

Note: These are the gaps relative to the US in terms of the ICRG composite index.

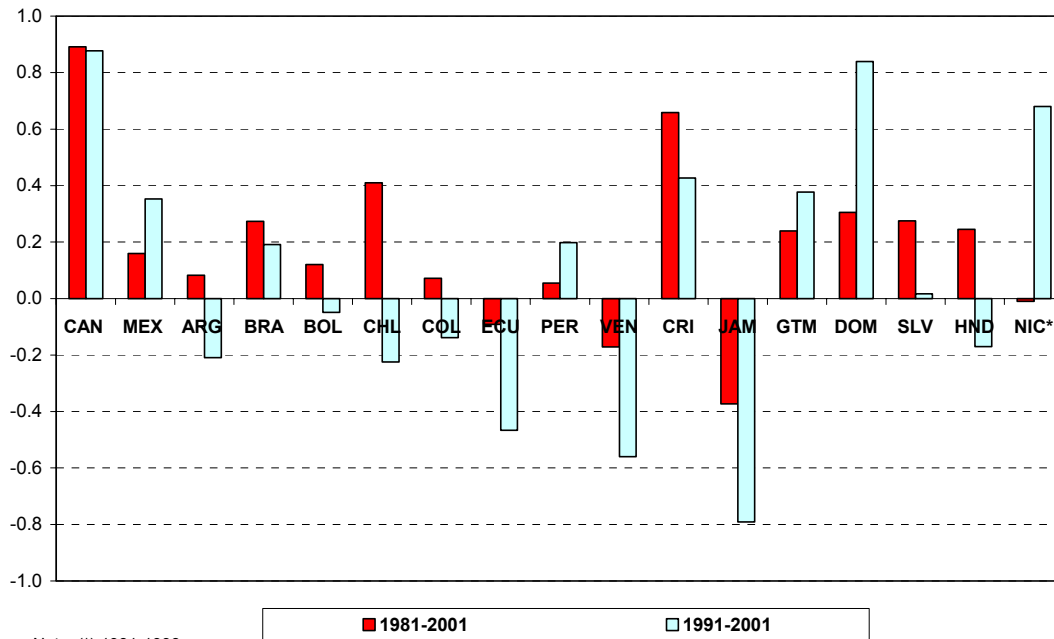
2. Macroeconomic synchronization and policy coordination

In addition to long-run effects on per capita income and wages, trade agreements also have potentially major implications for aggregate fluctuations in member countries and therefore for the design of their macroeconomic policies. Through increased economic integration, the macroeconomic cycles of partner countries may become more closely synchronized – although this is need not be invariably the case, especially if the countries involved are very dissimilar. A thorough review of the evidence shows that in the post-NAFTA years aggregate fluctuations in Mexico have become increasingly synchronized with those of its partners in the treaty (Chapter 2). Although the post-NAFTA period is still too brief to allow firm conclusions, this suggests that the nature of macroeconomic volatility in Mexico is changing, with developments in the U.S. accounting for an increasingly large fraction of the variation in Mexico's GDP growth. We may expect that the same will occur, to varying extents, to other countries after joining the FTAA.

This raises once again the issue of policy coordination. There is little ground for coordination among LAC countries alone, given their generally low degree of trade integration, the dominant role of idiosyncratic shocks in their macroeconomic fluctuations, and the absence of an obvious anchor country in the region whose policy credibility could enhance that of client countries. However, the prospect of an FTAA places the issue under a new light. Aggregate instability remains high in most LAC countries in spite of having fallen in the 1990s, and is a potential obstacle to the achievement of the full benefits of an FTAA in terms of resource reallocation and trade expansion – particularly so in the case of real exchange rate volatility. This poses the question of whether tight policy coordination with the U.S. – including options such as monetary unification with the U.S. through a currency union or unilateral dollarization – could help enhance macroeconomic stability and deepen integration.

At present, however, for most countries in the region the answer is likely to be negative. Their degree of trade integration with the U.S. is generally low, and the scope for asymmetric shocks correspondingly large (Figure 3). Although the latter may decline over time with deeper integration, as in the case of Mexico with NAFTA, the cost derived from the loss of policy autonomy that a monetary unification with the U.S. would entail likely outweighs any potential benefits in terms of increased credibility. Moreover, the prospects for a formal currency union with the U.S. – i.e., one including arrangements for seigniorage sharing, lender-of-last-resort functions and joint determination of monetary policy -- seem remote. As a result, the only viable form of monetary unification would be unilateral dollarization, which is even less appealing due to the added cost from leaving those three issues unresolved.

Figure 3. Latin America: Correlation in Annual Growth of Real GDP with the U.S.



Note: (*) 1981-1998

Looser forms of monetary coordination short of unification, while possible, are unlikely to be credible or effective in the absence of central institutions to oversee and enforce them. The same applies to fiscal policy coordination. While the external commitment imposed by common fiscal rules might help national governments push forward fiscal reform and consolidation, the absence of enforcement mechanisms and institutions is likely to render the rules largely inoperative. The very limited success of previous attempts at policy coordination in several LAC subregions also points in this direction.

Central America may provide the exception to the above considerations. Most of the countries in the area are highly open and integrated with the U.S. In addition, some of them suffer from low credibility and exhibit a high degree of *de facto* dollarization. On the whole, this would make them the most suitable candidates for monetary unification with the U.S. El Salvador has already taken this step, although more time is needed to assess its experience with dollarization.

In contrast, most of the larger economies in South America are likely to benefit from independent monetary policy, and several of them have already made progress with the implementation of flexible exchange rate regimes guided by inflation targets. For them the challenge is to establish a track record of monetary stability and low inflation to strengthen the credibility of the inflation-targeting regime.

On the fiscal front, the ability of most LAC countries to conduct countercyclical policy is severely limited by poor credibility, following from a tradition of large fiscal

imbalances, and by the weak operation of automatic fiscal stabilizers, reflecting narrow tax bases and, in several cases, the large weight of volatile resource revenues in total fiscal collection. In a context of deficient fiscal institutions, the result has often been a procyclical fiscal stance, which augments aggregate volatility instead of reducing it.

A solid fiscal position will require in many countries a tax reform to expand the revenue base – and, in some countries, also to offset the income loss from declining tariff collection derived from the FTAA. Maintenance of a firm position will reinforce credibility over time. But the credibility buildup could also be aided by explicit adoption of (and adherence to) contingent fiscal targets formulated in cyclically-adjusted terms, along the lines of Chile’s recent ‘structural surplus’ rule. These entail the achievement of fiscal surpluses in periods of expansion to provide room for deficits in times of recession. The creation of strong fiscal institutions allowing policy makers to implement these rules and abide by them is an essential ingredient of this process.

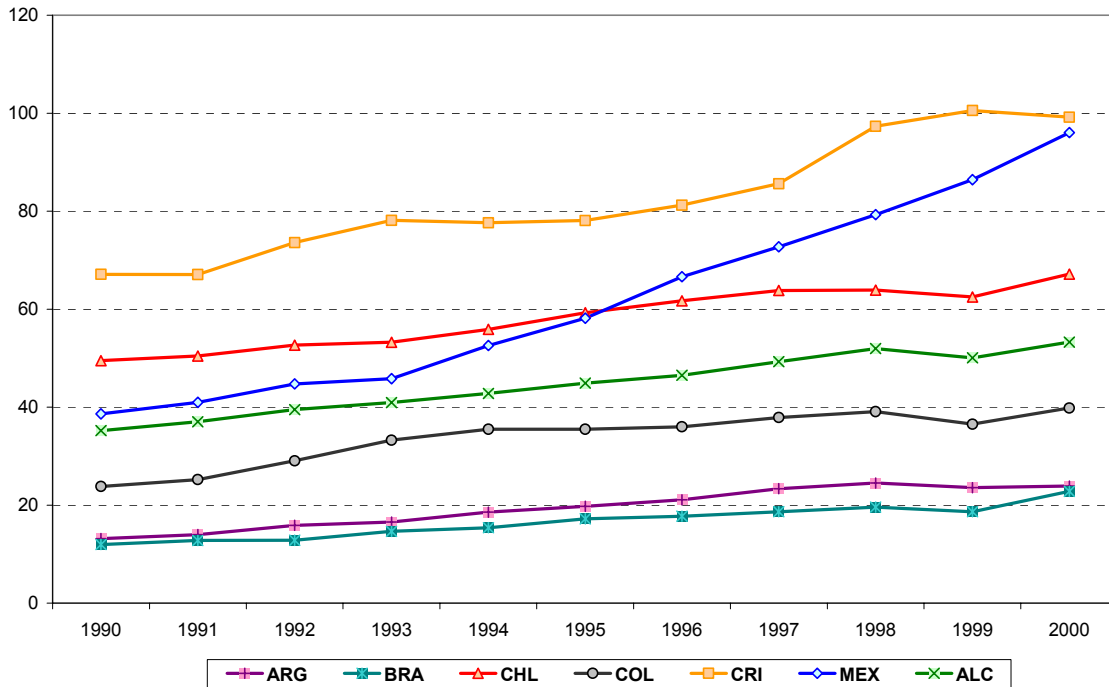
3. Trade integration

Mexico’s trade liberalization under NAFTA followed closely the unilateral reforms begun on 1986, after the country joined the General Agreement on Tariffs and Trade (GATT). Trade negotiations between Mexico, Canada and the U.S. began informally in 1990, and more formally in 1991 after the U.S. administration obtained “fast track” authority from its legislature. Thus, it is difficult to separate the effects of NAFTA on Mexico’s volume and composition of trade from those of the unilateral reforms, especially given that the mere announcement of NAFTA talks could have had an impact on economic outcomes. Nevertheless, it is clear that during the 1990s Mexico became one of the region’s economies with highest volume of trade relative to GDP. Indeed, Mexico caught up with Chile in this indicator of economic integration, and is fast approaching the high trade shares typically found among smaller economies such as Costa Rica (Figure 4).

The rapid expansion of Mexico’s trade began prior to NAFTA, approximately in 1993, and was accompanied by a marked change in its composition, through which Mexico became a net exporter of machinery in 1992-93. Thus, substantial changes happened prior to actual implementation of the free trade agreement, perhaps reflecting lagged effects of the unilateral reforms and/or their enhanced credibility due to anticipated passage of NAFTA.

However, in spite of the substantial unilateral and NAFTA-related liberalization achieved in Mexico, in some areas the effective degree of liberalization has been more limited than it could have been. The study examines three such areas: rules of origin and manufacturing trade, agriculture, and anti-dumping and countervailing duties.

Figure 4. Latin America: Imports plus Exports over GDP



3.1 Rules of origin

The study shows that NAFTA’s rules of origin, which like in other free trade agreements are used to identify products eligible for preferential treatment in order to prevent trade deflection from non members, can result in countries importing the structure of protection from their partners. Rules of origin impose a cost on exporters wishing to use FTA preferences for their exports. The cost can be so high as to make it more profitable for exporters to export subject to duties, rather than using the preferences, and thus avoid the requirements imposed by the rules.

An extreme case is that of the textile and apparel industries, where Mexico probably has imported the U.S. structure of protection. This occurred because the U.S. seems to be NAFTA’s low-cost source of textiles used in the manufacture of apparel. Since NAFTA offered substantial preferential treatment to Mexican exports of apparel that use textiles and yarns from NAFTA countries (mainly the U.S.), the decision whether to export to the U.S. apparel market depends only on the U.S. apparel and textile prices as determined by its import barriers. The evidence shows that Mexico has become a net exporter of apparel to the U.S., but not to the rest of the world, while being a major importer of U.S. textiles.

But a large share of Mexican apparel exports does not enter the U.S. taking advantage of NAFTA preferences. In fact, the use of those preferences by Mexican exporters is similar to the use of CBI/CBERA preferences by exporters in Central

America and the Caribbean, even though the latter impose stricter rules of origin demanding that the textiles used in apparel manufacture be entirely from the U.S. (Table 2). The recently-approved Andean Trade Preferences Act (ATPA) imposes similarly strict rules of origin to apparel exports to the U.S. from the beneficiary countries.

Table 2. Mexico and Selected Countries: Rate of utilization of NAFTA and CBI Apparel Preferences

	2001	Jan-Nov 2002
Mexico (NAFTA)	68%	74%
Costa Rica (CBI)	53%	65%
El Salvador (CBI)	57%	63%
Honduras (CBI)	62%	73%
Nicaragua (CBI)	21%	29%
Jamaica (CBI)	59%	88%
Dominican Rep (CBI)	68%	83%

Source: Authors' calculations based on data from the U.S. ITC.

Thus, for other LCR countries expecting their apparel and textile industries to benefit from a NAFTA-type deal, it is important to keep in mind that the relevant rules of origin might limit the magnitude of the desirable market access effect. For countries possessing a competitive textile industry, moving from CBERA (or ATPA) to NAFTA rules of origin might make a big difference. Using estimates of net exports of textiles and apparel, the Report argues that this will be the case for countries such as El Salvador or Colombia. But for other countries that will not be the source of low-cost textile and yarn inputs used in apparel, the change might not be very beneficial. Hence, for most countries in the region it may be preferable to amend NAFTA's rules of origin in this sector. One alternative would be to use regional value content rules, rather than the existing change of chapter rule, which in effect implies that all of the textile and yarn inputs in apparel need to be of regional origin. Yet for countries that use low-cost inputs from other regions, NAFTA rules of origin might be more harmful than what was observed for Mexico.

3.2 Agriculture

Contrary to some predictions, NAFTA has not had a devastating effect on Mexico's agriculture. In fact, both domestic production and trade in agricultural goods rose during the NAFTA years (Figure 5). The more challenging question is why NAFTA did not have the expected negative consequences. We offer three arguments. First, aggregate demand in the U.S. and Mexico grew in the latter half of the 1990s, thus allowing for simultaneous increases in Mexican production and imports. Second, some segments of Mexican agriculture experienced increases in land productivity. This was the case for irrigated lands, but not for rain-fed lands. Third, whereas the total amount of subsidies and income supports for traditional agriculture did not rise during the NAFTA period, Mexico's unilateral reforms did entail an improvement in the efficiency of such subsidies. In particular, the PROCAMPO program, which de-linked the amount of public support from current and future production decisions, became the main source of support

for farmers that had historically produced traditional crops such as maize and other grains (Figure 6).

The Report briefly discusses some key program design issues that should be considered when implementing de-linked agricultural support programs, based on the Mexican and U.S. experiences. In particular, the efficiency gains from the PROCAMPO program suggest that other countries liberalizing trade should also consider agricultural support schemes that provide incentives for productive transformation of the sector, rather than maintain incentives similar to those provided by protectionist policies that inhibit agriculture's transformation.

Figure 5. Mexico: Agricultural Production (mns of USD) and Trade Share, 1990-2001

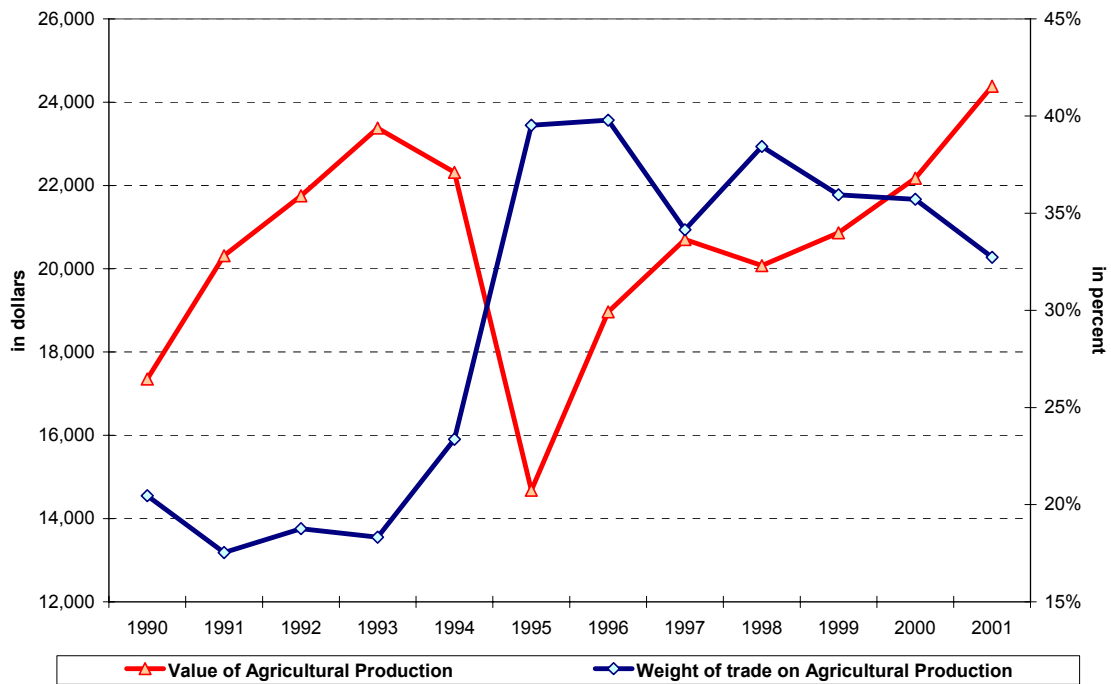
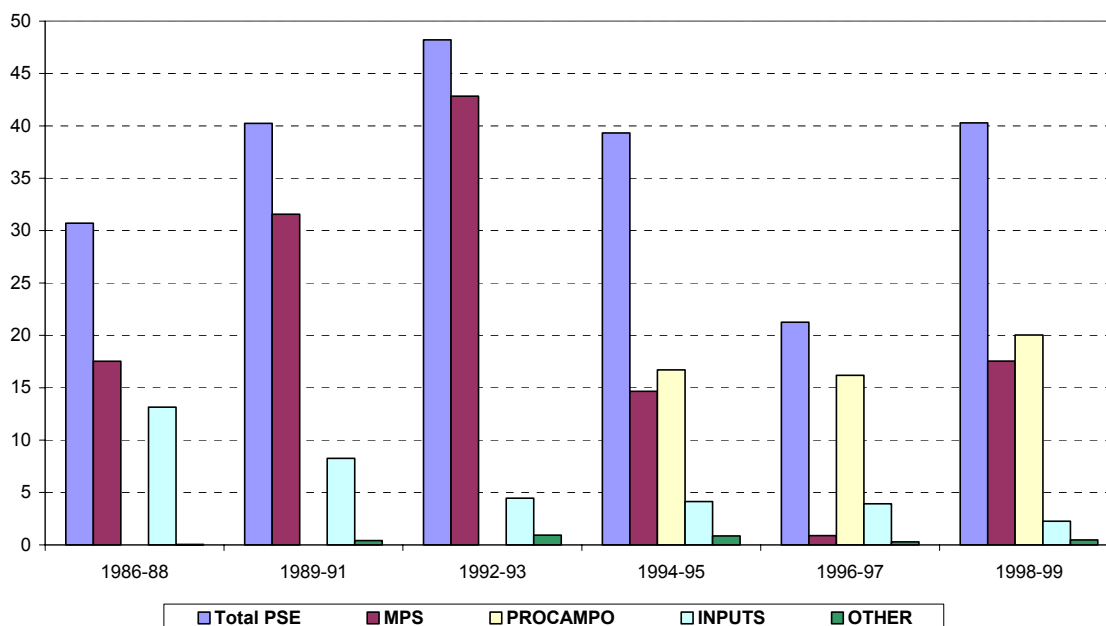


Figure 6. Mexico: Production Support Equivalent (PSE) by Type



Note: Traditional crops: maize, rice, soy, wheat, barley and sorghum.
Source: OECD (2000)

3.3 Anti-dumping and countervailing duties (AD/CVDs)

Regarding AD/CVD activity, the report finds two contrasting results. On the one hand, NAFTA’s Chapter 19, which provides a panel review mechanism for assessing whether AD/CVD decisions by the competent national agencies have been properly applied, has had no significant impact on U.S. AD/CVD activity against Mexico or Canada. The post-NAFTA period has conformed to tradition in that U.S. AD/CVD actions against Mexico and Canada have continued to be infrequent (Table 3).

On the other hand, there is some evidence suggesting that Mexico’s AD activity against the U.S. and Canada has been significantly lower after the implementation of NAFTA. However, the U.S. has traditionally been a major focus of Mexican AD cases. It is also notable that Chile rejected the U.S. proposed language on AD/CVDs in its recently finalized FTA.

For the upcoming FTAA, AC/CVD activity poses a key policy challenge. One option is to harmonize the antitrust regime among Latin American and Caribbean countries and the U.S. However, given the fact that AD/CVD laws in each country were designed with the explicit purpose of protecting domestic producers from “unfair” foreign competition, it is unlikely that such a process of regulatory convergence can be achieved in the forthcoming trade negotiations with the U.S. Another alternative is for each country to use its own AD/CVD laws to retaliate against any abuses by the U.S. or other countries – at the risk of trade wars and more rather than less protectionism. The third, preferred alternative could be to reach an agreement with the U.S. that would allow

the use of safeguards for regional trade relief rather than AD/CVD procedures. This would entail a regional negotiation of a new safeguards chapter stating clearly that regional import surges should be dealt primarily through this mechanism. This alternative is attractive in the short run because, in contrast to U.S. AD/CVDs, safeguard duties are temporary and require the action of the executive branch, in contrast with duties without sunset clauses supported by a supposedly technical and independent, but often unfair, trade machinery.

Table 3. Average Annual U.S. Antidumping and Countervailing Duty Filings

	Pre-CUSFTA Pre-NAFTA 1980-1988	Post-CUSFTA Pre-NAFTA 1989-1993	Post-CUSFTA Post-NAFTA 1994-2000
Against NAFTA partners			
Canada	3.9	4.3	1.6
Mexico	1.1	3.8	1.7
Against Other countries/regions			
Japan	7.6	6.3	3.33
European Union	32.7	20.3	8.3
Latin America	10.8	11.3	4
Asia	13.8	22.3	14.6
Rest of the World	14.1	11.5	9.1

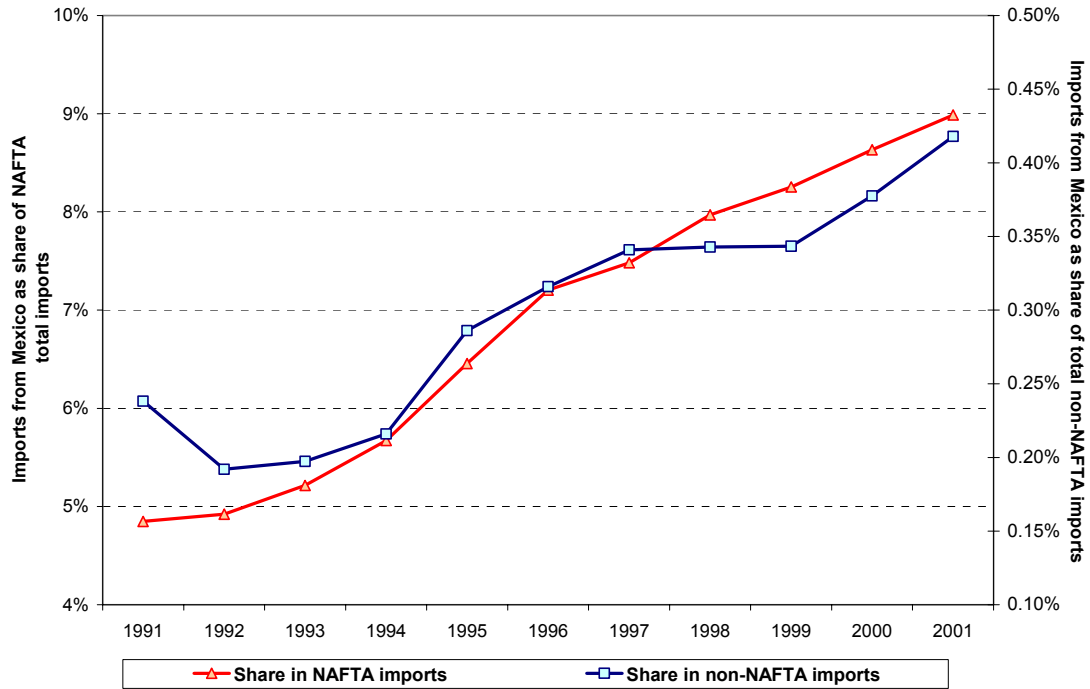
Sources: U.S. Antidumping Database available from the National Bureau of Economic Research webpage: <http://www.nber.org/antidump>, and official sources of the U.S. Department of Commerce and U.S. International Trade Commission

3.4 Trade diversion from NAFTA

When NAFTA was being negotiated in the early 1990s, many third countries voiced concern that their exports to the U.S. (and, to a lesser extent, to Canada and Mexico) would be displaced by NAFTA exports, even though in many products and industries those countries could be more competitive than NAFTA producers. From the viewpoint of Mexico, this trade diversion is also important because it would entail a loss of fiscal revenues from replacing imports from third countries subject to tariffs with duty-free imports from the U.S. or Canada.

From a thorough analysis of trends in aggregate trade flows, controlling for their basic determinants, the report finds little evidence of trade diversion at the aggregate level, a conclusion that agrees with previous studies of NAFTA. Indeed, such result is also suggested by the fact that Mexico's export share in non-NAFTA markets rose as much as, or even more than, its share in NAFTA markets (Figure 7).

Figure 7. Share of Mexico's Non-Fuel Exports in NAFTA and Non-NAFTA Markets



The report also examines the trends in apparel trade to assess if NAFTA's neighboring countries were hurt by trade diversion in this sector, as some studies have suggested. On the whole, there is not solid evidence that neighboring countries lost apparel market share due to NAFTA preferences. While all countries in Central America and the Caribbean faced the same change in U.S. preferences relative to those enjoyed by Mexico, their post-NAFTA performances showed considerable diversity. Most Central American countries managed to raise their export share in NAFTA markets, while Caribbean economies fared less well. This suggests that factors other than NAFTA preferences are responsible for much of this diverse post-NAFTA performance (Table 4).

Table 4. Shares in NAFTA's Total Apparel Imports

	1991-1994	1995-2001
Mexico	3.74%	10.76%
Costa Rica	1.79%	1.50%
Guatemala	1.48%	2.04%
Honduras	1.27%	3.28%
Nicaragua	0.03%	0.41%
El Salvador	0.67%	2.06%
Central America	5.24%	9.29%
Dominican Republic	3.76%	3.91%
Jamaica	1.05%	0.77%
CARICOM	5.00%	4.78%
Bangladesh	2.21%	2.88%
China	15.44%	11.71%
Hong Kong	14.54%	8.82%
Indonesia	2.82%	3.31%
India	3.24%	3.29%
Korea	6.67%	3.81%
Thailand	2.48%	2.82%
Taiwan	7.48%	3.84%
Asia	54.89%	40.47%

Source: UN-COMTRADE, Apparel HS 61, 62

Among such factors, export incentives granted by a number of countries in the context of Export Processing Zones (EPZs) may have played an important role. It is thus possible – although hard to verify -- that the upward trend in the region’s apparel export shares might have been achieved at significant costs derived from EPZ concessions, such as foregone fiscal revenues and other potential distortions. Looking to the future, WTO rules imply that EPZs incentives in their current form will have to be phased out, so that a new export- and investment-friendly framework will have to be developed by the countries involved.

3.5 Future trade negotiations for LCR countries: The multiple fronts

The likely benefits for LAC countries of an FTA with the U.S. and Canada go beyond the reduction of barriers to their mutual trade. On the one hand, an FTA implies a firm guarantee of market access, in contrast with preferences granted unilaterally by the U.S. (such as those under CBI/CBTPA and ATPA), which are offered on a temporary basis and subject to unilateral revocation at any time. Furthermore, unilateral concessions typically leave the resolution of trade disputes to the discretion of U.S. authorities.

On the other hand, an FTA can help “lock-in” progress made on unilateral trade liberalization, making it immune to protectionist pressures that might arise in the future.

It may also have a broader positive impact on credibility by offering investors, domestic and foreign, a more stable and predictable framework preventing backtracking not only in the rules governing international trade, but possibly in the reforms on other fronts as well. These lock-in and credibility effects, however, may vary considerably across FTAA prospective members. They are likely to be most important for countries at an early stage of trade opening whose reforms still suffer from poor credibility. For other countries which already possess low barriers to trade and a strong constituency in favor of trade openness, the credibility dividend will largely depend on the extent to which FTAA accession prompts improvement and strengthening of policies and institutions.

However, an FTAA also entails costs and policy challenges – negotiation costs, especially significant for small countries; fiscal costs derived from the elimination of tariffs against other FTA members, which for some countries will imply a sizeable shock requiring fiscal reform; and hidden costs such as the distortions imposed by ROOs under NAFTA, which, if not properly tackled in the negotiation process, can detract substantially from FTAA benefits.

Moreover, the anticipation of gains to be made from an FTAA does not reduce the need for continued progress with unilateral trade reforms and multilateral negotiations under the aegis of the WTO. Some key issues, such as those surrounding agricultural trade, are unlikely to be resolved in the context of an FTAA, as experience has shown that the U.S. is not prepared to deal with its own agricultural supports in the context of FTAs. The same is true for AD/CVD activity, although it is yet unclear whether the U.S. would be able to change its relevant laws even under a WTO-brokered deal. Finally, for some countries, especially in South America, trade agreements with Europe and the Doha Trade round are likely to be quite important for market access, perhaps to a greater extent in some areas than the proposed FTAA.

LAC countries should remain actively engaged in the Doha trade round. Argentina and Brazil are likely to be important players in the agricultural debate as members of the Cairnes Group of agricultural exporters, which also includes the U.S., Canada, and Australia, to push for important reforms in agricultural policies around the world. In this area, success of the WTO round in providing incentives for all countries to de-link their subsidies from production decisions -- as previously attempted by the European Union, and implemented by the U.S. and Mexico -- would be a significant improvement over the current situation, where only 5% of the average OECD agricultural support is based on historical harvests. If one excludes the U.S. (20%) and Canada (9%), the average of the rest of the OECD is even lower. Since the process of EU enlargement is already bringing to the fore the sustainability of Europe's Common Agricultural Policy (CAP), it is likely that in the future there will be room for compromise on agricultural subsidies.

Regarding unilateral liberalization, the analysis in the report suggests that much of the gain in export market share achieved by Mexico in recent years reflects its unilateral trade liberalization since the late 1980s. The implication for third countries is that trade-friendly policies, even if unilateral, can yield large dividends in terms of export market

expansion. Moreover, there is no convincing evidence that higher initial tariffs can help developing countries attain better market access to industrialized countries in trade negotiations, as some have suggested. On the contrary, developing countries with weak credibility may need to lower tariffs in order to signal their willingness to implement further trade reforms as mandated by potential trade agreements. It is not a coincidence that the U.S. negotiated NAFTA after Mexico had unilaterally reformed, and that Chile was the next country in line, closely followed by Central America, which as a whole is among the most open economies of the region. Thus, the report concludes that LAC countries should pursue unilateral and multilateral reforms, while simultaneously negotiating FTAs with the U.S. and other countries. In fact, this has been the Chilean model for some time.

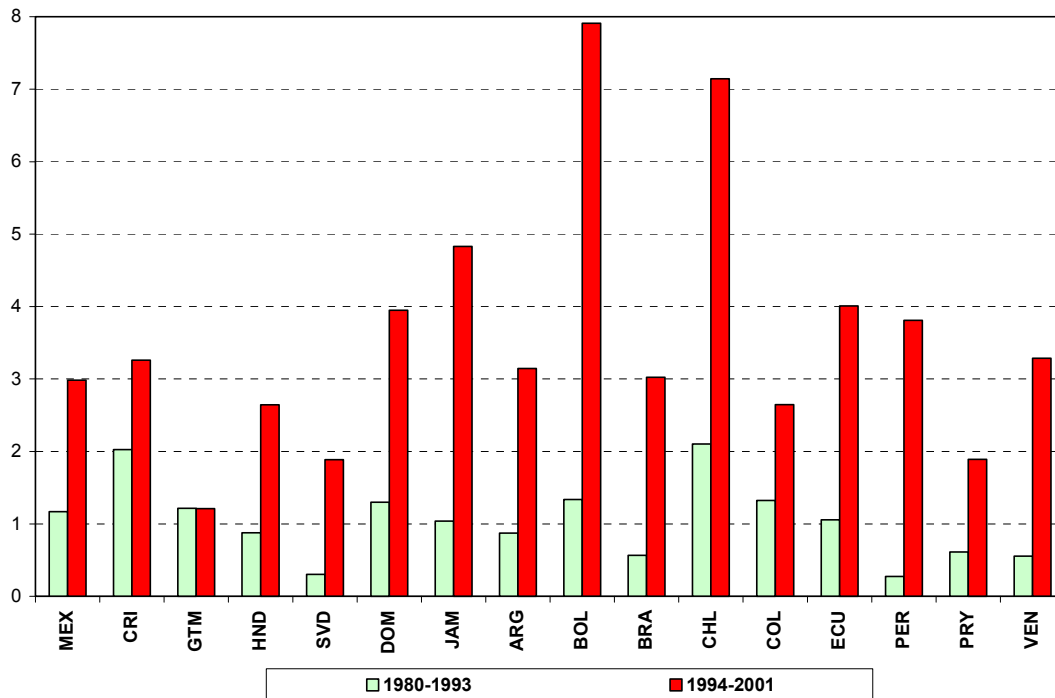
4. Factor markets

While Free Trade Agreements are about trade by definition, they also have potentially major consequences for the allocation as well as the retribution of labor and capital, for several reasons. First, theory suggests that trade should lead to greater convergence of the returns to capital and wages among the trading partners, reflecting increased efficiency in the allocation of factors. Second, FTAs may include explicit provisions removing barriers to international movements of capital (like in NAFTA) and/or labor (like in the EU). Finally, but not less importantly, FTAs may reduce the perceived risk from investing in member countries, by providing a guarantee of access to the extended market defined by the agreement, and by locking-in the trade and other policies of participating countries.

4.1 Capital

Through the above channels, an FTA may deepen the degree of financial integration -- in addition to trade integration - of its member countries. In particular, it may prompt a substantial rise in foreign investment inflows to FTA newcomers. Indeed, the anticipation of higher FDI is probably one of the main benefits that prospective members expect from the upcoming FTAA. The experience with NAFTA appears to validate these expectations: aggregate FDI flows to Mexico did rise significantly in the period following NAFTA, and econometric analysis suggests that the trade agreement played an instrumental role in the rise (Chapter 4). On the whole, however, Mexico's FDI performance in the post-NAFTA period was not significantly above the Latin American norm, except in the years immediately following passage of the treaty (Figure 8). Nor is there much evidence that increased investment in Mexico came at the expense of other countries in the region -- i.e., that NAFTA led to investment diversion. The neighboring countries of Central America and the Caribbean, which stood to lose the most from a redirection of FDI flows to Mexico, did not show a generally worsened performance as investment hosts after NAFTA (Chapter 7).

Figure 8. Latin America: Net FDI Inflows as Percentage of GDP (annual averages by period)



Taken together, this evidence indicates that while an FTAA is likely to encourage FDI to LAC member countries, it is neither necessary nor sufficient for such result. Chile has experienced persistently large FDI in the absence of an FTA, while Greece derived no immediate FDI benefits at the time of its EEC accession. In other words, an FTAA is a complement, rather than a substitute, for an investment-friendly policy and institutional environment, and it cannot make up for macroeconomic instability and weak institutions. Thus, countries hoping to benefit from FTAA-induced investment creation need push forward with reforms aimed at improving investment fundamentals: economic and policy stability, productivity, institutions and governance. While there is considerable diversity in the region, along most of these dimensions LAC countries still lag behind other developing regions such as East Asia.

This strategy centered on improving the investment climate for both domestic and foreign investors should replace the export-based FDI incentives that have been at the core of FDI-attracting efforts in a number of countries, notably Central America and the Caribbean. As already noted, such incentives will soon cease to be feasible under WTO rules. Tax concessions and other incentives are less important than FDI fundamentals for investment location decisions, although they do have some impact when the choice is among hosts with similar fundamentals. However, incentives can also be distorting and wasteful if the investments they attract do not involve significant positive externalities. To minimize their costs, incentives should be rules-based, and available on equal terms to all investors irrespective of nationality.

The key concern for host countries is not the volume of FDI they may receive, but the benefits that it brings to the economy. Reforms in anticipation of an FTAA have to focus also on the key determinants of those benefits, even if they do not directly affect the volume of FDI inflows. In particular, for the domestic economy to absorb any technological spillovers arising from FDI, sufficient levels of human capital and an adequate knowledge and innovation system need to be in place (Chapter 5).

However, increased FDI and international financial integration do not guarantee that firms will be able to take full advantage of the new opportunities offered by the FTAA and speed up income convergence in the Americas. The vast majority of firms in LAC -- especially smaller and new ones -- cannot resort to foreign financial markets, and their access to domestic finance is constrained by the deficiencies of local financial markets. To a large extent, the small size and illiquidity of these markets reflect legal and institutional shortcomings regarding the protection of creditor and shareholder rights, which in most Latin American countries is far weaker than in industrial countries and East Asia (Chapter 4). Thus, legal and regulatory measures to strengthen investor protection should rank high in the reform agenda.

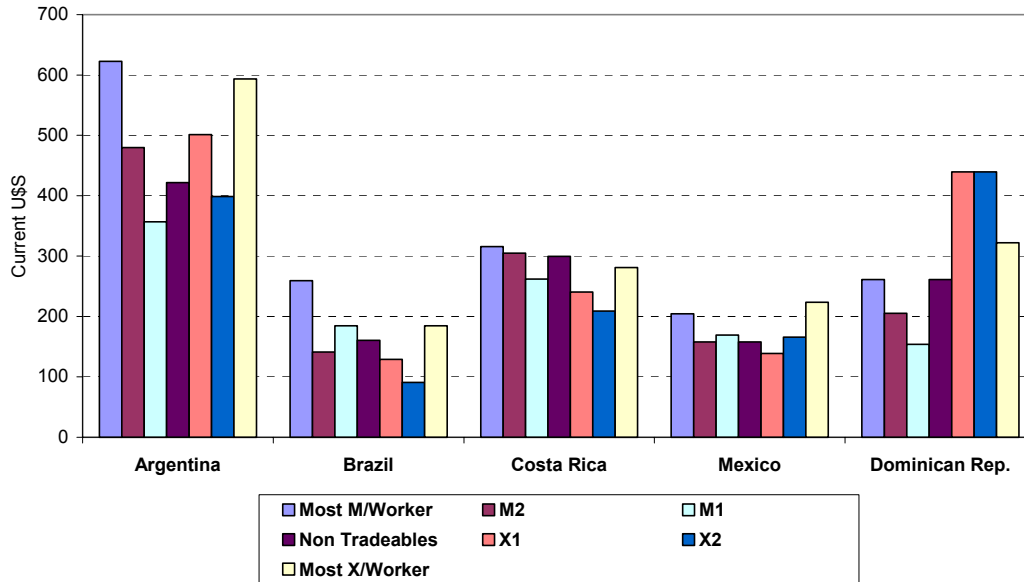
4.2 Labor

Regarding labor, the lessons emerging from Mexico for other countries contemplating the FTAA are necessarily tentative, but the overall evidence suggests that cautious optimism is warranted. There is some evidence of convergence towards U.S. wage levels, but inference is made very difficult by the collapse of Mexican real wages following the Tequila crisis. Though manufacturing wages rose after unilateral liberalization and sharply in the years following NAFTA, there is no strong evidence that this was particularly due to convergence through trade. On the one hand, wages are higher, and have grown faster, in states with more trade, FDI, and presence of maquila. On the other hand, the apparently tighter integration of wages along the border, in traded and non-traded industries alike, suggests an important role for migration in driving the limited convergence seen so far. Perhaps a longer-run view is offered by Chile which, after its very similar version of the Tequila crisis following unilateral liberalization in the early 1980s, generated real wage growth of an impressive 3.2% per year from 1986 to the present, with impressive declines in rates of poverty.

In spite of popular perception, there is little ground for concerns that NAFTA, or FTAs more generally, are likely to have a detrimental effect on the availability and/or quality of jobs. Consistent with the region-wide evidence, there is little indication of higher unemployment, increased volatility of the labor market, or increased informalization associated with trade liberalization. In fact, Mexican firms, as those of the region more generally, that are more exposed to trade tend to pay higher wages adjusted for skills (Figure 9), are more formal, and invest more in training. The probably temporary widening of the wage gap between skilled and unskilled workers observed throughout the region can be seen as reflecting a welcome increase in the demand for

skilled workers by new and upgrading firms.¹ However, it does imply, as discussed below, that the FTAA will require a more vigorous effort in raising the level of human capital.

Figure 9. Latin America: Wages Adjusted for Skill by Degree of Exposure to Trade



Note: M1 and M2 are progressively the terciles of industry most exposed to imports. X1 and X2 are progressively the terciles with the most exports.

It is more difficult to identify the labor market policies best suited to complement the FTAA. In the short run, an FTA may lead to significant reallocation of jobs from sectors not in a country’s comparative advantage to those that are, and such reallocation is essential to take advantage of the gains from trade. Over the longer run, more dynamic economies are likely to require higher turnover of workers as new technologies are adopted and new firms and sectors are created, expand and die. Labor legislation ideally needs to facilitate the transition of workers from dying to expanding industries, while protecting their livelihoods in the process. A more general question is how labor markets adjust to major macro-economic shocks of the kind facing Argentina, Brazil, Colombia and Mexico, for example, during the 1990s. The present evidence from Mexico does not suggest that openness in itself has led to more shocks to the labor force, but the issue is important in order to interpret the evidence from the various experiences in the region.

At the time of NAFTA’s signing, the Mexican labor market was reasonably flexible and showed few nominal rigidities. Mexico’s low levels of unemployment, with the exception of the Tequila aftermath, reveal the economy’s ability to carry out

¹ The region-wide trends in the quality and availability of jobs, as well as skill premium and its determinants, are amply documented in LAC’s recent flagship reports “From Natural Resources to the Knowledge Economy” (2001) and “Closing the Gap in Education and Technology”(2002).

necessary sectoral reallocations without major adverse labor market outcomes. Even during the crisis, Mexico engineered sharp falls in the real wage by allowing inflation to erode pact-guided wages and thereby avoided very high rates of unemployment. Arguably, this is the critical difference with countries such as Argentina and Colombia, whose macro-economic crises during the 1990s in a framework of relatively rigid real wages have led to high and sustained unemployment. What Mexico's experience suggests is that neither prolonged spells of unemployment nor degradation of the quality of jobs are inevitable, or even likely, results of an FTAA.

A greater concern for all countries considering FTAA's is the inability of firms to make adjustments to their labor force at moderate and predictable cost, and the lack of safety nets for workers where such adjustments are possible. Mexico is very representative of South and Central America (although not the Caribbean) in prohibiting worker layoffs for economic reasons and imposing costs for dismissals roughly double the advanced-country average. In fact, Brazil, with the lowest separation costs in Latin America, is only slightly above the advanced-country average while Bolivia at the high end shows costs that almost triple those of industrial countries. The lack of an orderly system of separations for economic reasons leads to highly litigious dismissals that raise transaction costs for firms and uncertainty for both parties about the final compensation. The system discourages the ongoing reallocation of workers to better job matches, impeding the gains in labor productivity that are a hoped-for by product of the FTAA. It also represents a very poor form of protection for workers. Absent individual accounts such as those implemented in Colombia or Chile, or an unemployment insurance program such as that of Brazil, their source of income in case of a firm collapse is the ailing firm itself, exactly the wrong agent to bear the risk. In sum, Mexico's labor code, like many of those of those in countries considering the FTAA, probably serves neither workers nor employers well, and is likely to become more of an impediment in the context of more open, competitive economies following regional trade liberalization.

5. Innovation

The deficiencies in the educational and innovation systems of most Latin American and Caribbean countries pose a critical constraint on their ability to catch up with the U.S. As described in the recent World Bank LAC flagship report on "Closing the Gaps in Education and Technology in Latin America and the Caribbean," these deficiencies affect virtually every country in the region. The corresponding policy issues are discussed in more detail in that report as well.

The main *educational gaps* in Latin America and the Caribbean are those related to the coverage of secondary enrollment and the poor quality of the education provided to its citizens. Attainment along these dimensions in Mexico, as well as in most of the countries in the region, is below the international norm for countries with similar levels of income.

The region as a whole also lags the international norm in *total R&D effort* as well as in the efficiency of such effort. Total R&D effort and patenting activity fall short of

the levels typically found in countries with similar characteristics. The international evidence suggests that the region's R&D investment effort should be about 2.5 times its current level, which during the late 1990s was approximately 0.4% of GDP in Argentina, 0.6% in Mexico, 0.8% of GDP in Brazil, compared to over 2.5% in the U.S. and Korea. NAFTA's main contribution to Mexico's innovation effort might have been its Chapter 17 on Intellectual Property Rights, since our analysis suggests that stronger protection is associated with higher levels of R&D spending relative to GDP.

The *inefficiency of the region's innovation systems* is reflected in a level of patents received for each dollar invested in R&D that is significantly below the OECD average, which itself is substantially below those of Korea, Taiwan, Sweden and Finland. Of all the countries in LAC, only Costa Rica and Venezuela rank among the high-efficiency performers. This regional inefficiency seems to be associated with the lack of linkages between the productive sector and the universities and public think tanks, which in turn do not provide incentives for its researchers to participate in productive R&D efforts. These deficiencies are reflected in the private sector's perceptions concerning the quality of the research conducted in the universities and in the extent of collaborative projects between universities and private firms.

The *region's lag in innovation outcomes* is thus reflected in the fact that the number of U.S. patents granted to regional researchers is significantly below what should be expected on the basis of GDP, labor force, and exports to the U.S. (Figure 10). In contrast, the evidence also identifies a group of high-performing natural-resource rich countries (Australia, Canada, Finland, New Zealand, Sweden, and Norway) which, along with East Asia and the Pacific region, do much better than the international norm.

An adequate innovative capacity is essential to fully exploit the potential of NAFTA and the upcoming FTAA. To develop it, the region needs to intensify its progress in education, both in terms of coverage and quality, and make a strong effort in innovation spending. This can be accomplished by reviewing the public incentives to R&D and overhauling what is, for the most part, a dysfunctional National Innovation System.

Figure 10. LAC's Gap in Patent Counts Relative to the Average and the Patenting Over-Achievers

