State of Play on Hemispheric Economic Integration

The tasks ahead for hemispheric economic integration seemed reasonably clear following the Summit of the Americas held in Miami from December 9-11, 1994. There was an end objective: the conclusion of "the negotiation of the Free Trade Area of the Americas (FTAA) no later than 2005." There was also a sub-objective: an agreement that "concrete progress toward the attainment of this objective will be made by the end of this century." There was an institutional arrangement to convene a meeting of ministers responsible for trade in June 1995, with a second such meeting in March 1996. The Organization of American States (OAS) was directed to help the host country in arranging the ministerial meetings.¹

Then, on December 20, a little more than a week after the summit, Mexico devalued the peso. The fallout from this action is still playing itself out. Canada's dollar continues to depreciate; its spot value is about U.S. 71 cents as this is written. One of the reasons for the peso rescue effort launched by the United States, with the help of the International Monetary Fund (IMF) and the Bank for International Settlements, was to forestall pressure to shorten the U.S. dollar. This may work eventually, but it has not so far; as this is written, the dollar's value is 97.4 yen and 1.4802 DM, both lows.

As a consequence, NAFTA itself is under attack. Mexico's current account goal is to cut the deficit in half in 1995--from close to $30 billion in 1994--but the reduction may turn out to be greater. This will affect U.S. exports to and imports from Mexico. The U.S. trade deficit with Canada widened in 1994 despite Canada's buoyant economy. In this atmosphere, support for extending free trade to other countries in the hemisphere is lukewarm--and actually hostile in some quarters.

This analysis looks at where we are today with respect to hemispheric free trade and what the future might bring.

Where We Are

The machinery for moving forward on the agreements made at the summit is in place in the sense that the United States will host the first meeting of ministers responsible for trade and the OAS has hired a coordinator for carrying out the duties it was given. The OAS has the cooperation of other key inter-American institutions in meeting its tasks, particularly the Inter-American Development Bank and the Economic Commission for Latin America and the Caribbean.

The three NAFTA countries have agreed to begin negotiations for Chile's accession no later than May 1995, and even now they are examining the compatibility of Chile's trade and economic legislation and regulations with the provisions of NAFTA. In the southern part of the hemisphere, the four countries of MERCOSUR (Argentina, Brazil, Paraguay, and Uruguay)

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¹. The United States will host the first meeting in June in Denver.
began their customs union on January 1, 1995 and presented a plan that is more or less precise on reaching a common external tariff (CET), but with some delay for controversial commodities such as computers, automobiles, and capital goods. Chile is negotiating with MERCOSUR for association by means of a free trade area (FTA).

There is considerable doubt about the plans of the other subregional integration arrangements. Peru and Ecuador have at least reached an armistice on their border dispute, but the Andean Group as a whole nevertheless has an unpromising future. Colombia-Venezuela trade, which had grown dramatically since the two countries reached an FTA in 1992, is now in a perilous position because of the continuing exchange restrictions in Venezuela and the uncertainty about its economic policy.

The countries of the Caribbean Common Market (CARICOM) have almost diametrically opposed views on what the region's next steps should be--whether to seek accession to NAFTA (Trinidad and Tobago), to consider accession (Jamaica), or to focus on extending existing preferences (from the European Union for the Lomé countries in the Caribbean, and from the United States under the Caribbean Basin Initiative for all of them). The Central American Common Market (CACM) is split; Costa Rica has an FTA with Mexico, three other countries (Guatemala, El Salvador, and Honduras) have toyed with taking similar action, and Nicaragua is still struggling with rectifying its economic turmoil.

The positive reality in the hemisphere, however, is that, with the major exception of Venezuela because of its exchange controls, imports are now freer than at any time in the post-World War II period. The explosion of preferential arrangements has led to significant increases in intrahemispheric trade. New vested interests in this increased trade are being created daily. Chile looks to Argentina, Argentina and Brazil to each other, the smaller countries of MERCOSUR (Paraguay and Uruguay) to the larger ones, Venezuela and Colombia to each other, Mexico and Canada to the United States - just to name some of the growing trade linkages.

There is thus much agreement on trade issues in the hemisphere, but much still remains unclear. The areas of agreement are not insubstantial and include the following:

- the desirability of open integration; that is, preferential trade between two or more countries but behind relatively low barriers against imports from outsiders;
- the end objective of joining the many partial agreements that exist--partial in the sense of not including the entire hemisphere--into a single FTAA; and
- an institutional structure for negotiating to this end.
The areas of uncertainty that now prevail are also quite formidable and include the following:

- how the hemisphere gets from here to there, from the multiplicity of preferential agreements that exist to a single hemispheric FTAA;
- the form of this FTAA, whether a single agreement, such as that which might exist if there were universal accession to NAFTA, or some merging of the separate preferential agreements through a series of FTAs; and, above all,
- the thinking of the two major countries of the hemisphere--the United States and Brazil--on these issues.

Brazil has thus far made clear that its first integration priority is to deepen MERCOSUR and only then consider its--or MERCOSUR's--relations with NAFTA. The fact that it takes the form of a customs union with a CET means that the intention is to have MERCOSUR act as a unit in negotiations with nonmember countries. MERCOSUR has also indicated its willingness to achieve FTAs with other countries in South America, such as Chile (with which negotiations are already taking place) and Bolivia.

Beyond the agreement to negotiate with Chile, NAFTA has no such clear program. The United States lacks fast-track authority, which hampers much future action. The one promise that exists is that fast-track authority will be sought in 1995 to permit submission of a Chile-NAFTA agreement to the Congress. Canada has made it clear that it wishes to expand NAFTA to the hemisphere and may even be prepared to sign its own FTAs with Latin American and other countries should the United States find itself unable to make progress. Mexico, for the moment, is unable to even consider any progress on expanding NAFTA. Even Mexico's FTAs with Chile, Colombia, Venezuela, and Costa Rica are uncertain arrangements in view of the sharp depreciation of the Mexican peso.

**Possible Paths Toward an FTAA**

The different attitudes toward hemisphere integration raise the issue of reconciliation of the various views. Chile is prepared to hedge its bets and seek simultaneous accession to NAFTA and affiliation with MERCOSUR, but it may be unique.

Colombia and Venezuela trade much more with the United States than with MERCOSUR countries. They may consider a MERCOSUR affiliation in the same way that Chile is pursuing this only because NAFTA is not open to them, either because of the obligations they must assume or U.S. unwillingness or inability to consider their accession. If Trinidad seeks accession to NAFTA, as it has indicated it wishes to do, this destroys even the meager unity that exists in CARICOM.
In the past, the main options for reaching an FTAA were believed to be either through accession to NAFTA by individual or groups of countries or through first consolidating subregional FTAs, which could then reach their own agreements with NAFTA (such agreements could be FTAs and not necessarily accessions). These options still exist.

But what of subregional agreements in which there is no internal coherence or little chance for consolidation? This seems to be the case for the Andean Group, CARICOM, and the CACM— that is, for the majority of countries in the hemisphere. And what is the path for countries unable or unwilling to undertake NAFTA obligations? This, too, applies to most countries in the hemisphere. Some may seek affiliation with MERCOSUR, but this offers little attraction outside of South America, almost outside of the southern part of South America.

At present, therefore, the situation seems to be the following:

- one country, Chile, is embarked on dual negotiations, for accession to NAFTA and association with MERCOSUR;
- Bolivia may be a candidate for association with MERCOSUR;
- Trinidad and Tobago has indicated its desire for accession to NAFTA; and
- for all the rest, there is uncertainty.

The uncertainty extends beyond the potential affiliating countries, but also within the core of the subregional arrangements. The U.S. executive branch not only does not have fast-track authority, but lacks any clear indication of what a new authority should contain, especially with respect to environmental and labor conditions.

Under these circumstances, a number of options must be considered in addition to the two conventional ones. These are (1) hemispheric agreements in specific functional areas, such as investment, intellectual property, and dispute settlement, or (2) agreements less than hemispheric in these areas, but ones that could be extended to other countries. Such agreements could be considered stepping stones to an eventual FTAA. They have a shortcoming in that they may be stepping stones to no place, but they do permit forward movement.

An additional option is a core agreement among countries prepared to undertake the full obligations of NAFTA and affiliations by other countries taking on lesser obligations. This has been called the concentric circle approach. In its way, this is the MERCOSUR path—a customs union among the four member countries and FTAs between MERCOSUR and other countries in South America. The major shortcoming of this approach is that an affiliation agreement, if it is to have any validity, would as a minimum require a timetable for the elimination of tariffs and nontariff barriers between the affiliating and NAFTA countries—and once agreement went this far, why not go all the way?

Some Issues Raised by the Mexican Experience

It will be difficult in the United States to secure approval for future FTAs, including expansion of NAFTA, without some understandings on exchange-rate issues. There is much sentiment that the
United States bought a pig in a poke in the Mexico agreement because all the ground rules have changed now that the peso is worth some 40 percent less than when NAFTA went into effect. The depreciating Canadian dollar raises similar concerns, although perhaps not as intense because the decline in the Canadian dollar has been more gradual.

This is a complex theme. None of the three NAFTA countries wished to conclude a customs union because this implied one further degree of loss of economic sovereignty (because of the CET and a common commercial policy) than in the case of an FTA. The United States clearly was not prepared to accept a common market and the free movement of labor this implies. And it is even more clear that none of the three countries is prepared now to consider monetary union and the requirement this involves for prior convergence on fiscal deficits and inflation.

Yet, there is much sentiment in favor of some arrangement that would limit future violent or persistent changes in exchange-rate relationships. It is difficult to see how this can be accomplished. In the debate on the loan guarantee for Mexico, there was much sympathy for the idea that Mexico adopt some form of currency board that would limit its central bank's ability to expand the money supply. This idea may not be feasible now, but will certainly not be discarded. There is also concern over Canada's fiscal situation and the effect this is having on the Canadian dollar.

But there is only one near certainty in this area among the current NAFTA members, and this is that the issue of exchange stability is on the table. One sure outcome is that there will be a much more concentrated consultation among the three treasuries and the three central banks. This consultation presumably will include future applicants for accession. Is more intense technical consultation enough to assuage concerns that there will be wide swings in future exchange-rate relationships? This is by no means clear.

The Mexican experience has raised a second, related, concern. The U.S. and international program of support for the peso was based on the fear that a Mexican default on its financial obligations might trigger financial havoc over a wider area. The rescue package was considerable: $20 billion from the U.S. Exchange Stabilization Fund; $17.8 billion from the IMF, $10 billion from the Bank for International Settlements, $1 billion from other Latin American countries, and some uncertain amounts from private banks.

Was a package of this size pulled together because Mexico was joined with the United States in NAFTA? The answer is probably "yes," at least in part. Would similar rescue packages, scaled to the need of the country, be mounted for other NAFTA countries? Or put differently, would an expanded FTAA require some facility for short-, medium-, and perhaps long-term financial support for member countries similar to that which existed in the European Community even before the Maastricht Treaty and the proposal for reaching economic and monetary union? Or can such financial assistance be handled through expansion of IMF resources?

This discussion raises issues of moral hazard. Why bail out private investors who put their own and their clients' money into Mexican instruments? Why come to the rescue of countries if there is not first some surveillance and policing mechanisms, either within an integration arrangement or on the part of the international community as a whole? It was not unknown that Mexico was running a large risk in the way it was financing its large and growing current account deficit. Considering the fallout on others when the risk became a meltdown, should this policy have been allowed to remain solely a Mexican prerogative? The name of Mexico is used here, but the question should be applied to other countries as well.
These are not easy issues, but they are certain to arise as the hemisphere moves ahead on an FTAA. They may arise in MERCOSUR should Brazil not get its finances and inflation under durable control or if the overvaluation of the Argentine peso proceeds much further. Financial uncertainty in Venezuela has already limited the benefits other hemispheric countries hoped to gain from exports there.

Wrapping Up

There is more uncertainty today about hemispheric free trade than there is agreement. The uncertainty is stimulated by the different approaches of the major subregional countries--the United States and Brazil; by the Mexican financial meltdown; and by the ambivalence demonstrated by the majority of countries in the hemisphere. The most desirable option is a single FTAA with comparable benefits and obligations for all, but this looks doubtful.

The positive side to the situation is that there is a commitment undertaken by all hemispheric countries to achieve an FTAA by a date certain, and machinery exists to work out the procedures.

My expectation is that the process of getting to hemispheric free trade will proceed by fits and starts and will include NAFTA accession negotiations, associations with MERCOSUR, continuation of bilateral preferential agreements, understandings in a number of functional areas, and continuation for a time of such existing preferences as the Caribbean Basin Initiative and those under Lomé. This will lead to some form of hemispheric FTAA only if the major powers insist repeatedly that this is the objective. The outcome, I conclude, depends primarily on the determination of the United States and Brazil to achieve an FTAA--and at this time I am not sure of either.
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This paper is an adaptation of a speech given at the Institute of the Americas in La Jolla, California.
Prospects for Hemispheric Trade and Economic Integration

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Policy Papers on the Americas
Volume VI Study 2

March 1995

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