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are all factors which are probably just as significant with regard to overcoming Latin America's problems in the 1990s as access to foreign borrowing.

### Conclusions

To conclude, it should be noted that there are now a number of positive developments in the making in Latin America which certainly justify the description of the 1990s as the region's "década de esperanza". However, the optimism expressed by the slogan is tempered by the unresolved question of where the development finance will come from, which could give rise to a serious bottleneck in the years to come. What can be done to avert this danger? The greatest priority must be attached to improving countries' net flow of funds relative to the rest of the world, as expressed in the real resource transfer. To

do that, Latin American exports need to be promoted, not least via greater opening of markets on the part of industrial countries, and a further need is for an increase in private-sector direct foreign investment, but above all for an increase in new lending from foreign public-sector sources.

Not until a marked increase has occurred in this external contribution, assuming domestic stabilization measures are also continued, can renewed growth be expected to occur in domestic savings, and hence also in the gradual establishment of a firm basis for strong, steady economic growth. Unfortunately, though, there are signs that the danger of a number of Latin American countries suffering another "década perdida" in the 1990s has not yet been banished.

Diana Brand\*

## Free Trade in Latin America: A Successful Way Out of Crisis?

*Since the beginning of the 1990s almost all Latin American countries have begun to change their strategies from protectionism to free trade. Historically, plans for regional economic integration have a long tradition on this continent, but attempts to bring them to fruition have failed time and time again. This report surveys past developments and attempts to show the prospects of success for the current free trade strategies in Latin America.*

Latin American countries have tried repeatedly in the last thirty years to form trading blocs and to cooperate on a regional level. Table 1 gives an overview of the composition and objectives of the various economic integration groups which were founded between 1960 and 1980 with the primary motive of liberalizing trade. Even though some of these groups showed considerable initial success, integration has always failed in the long term.

The ambitious aims of the Latin American Free Trade Association (ALALC or LAFTA), founded in 1960, did not come anywhere near being achieved in the twenty years of its existence. The main reason for the failure was the differing degrees of industrialization in the member countries, which led to an unequal distribution of the advantages of liberalization.<sup>1</sup>

Conflicts over distribution were also partly responsible for the failure of the Central American market, MCCA,

formed by a small number of basically relatively homogeneous countries in 1960. Repeated political disagreements and external shocks also prevented the long-term success of trade integration.

When Bolivia, Chile, Ecuador, Colombia and Peru formed the Andes Group in 1969, the aim was to strengthen the economic power of the above countries within ALALC relative to the predominating economies of Argentina, Brazil and Mexico. The realization of free trade plans failed, first and foremost, due to the national egoism of the participating countries. Economically, the heterogeneous industrial structure of the member countries hindered the implementation of a common external tariff.

<sup>1</sup> Cf. for example R. J. Langhammer and U. Hiemenz: Regional Integration among Developing Countries, Kieler Studien No. 232, Tübingen 1990; and Ricardo French-Davies: Economic Integration in Latin America, in: M. Urrutia et al. (eds.): Lessons in Development, A Comparative Study of Asia and Latin America, San Francisco 1989, pp. 157-180.

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The Caribbean Common Market CARICOM, founded in 1973, was born out of the Caribbean Free Trade Association CARIFTA, dating from 1968, in which 90% of the inner-zonal exchange of goods had already been liberalized. Here again, the complete liberalization of trade failed due to the differing levels of development in the participating countries.

The Latin American Integration Association (ALADI or LAIA) was founded in 1980 as the successor organization to ALALC. Past mistakes were to be avoided by a more flexible management of trade liberalization time-wise, by bilateral and limited multilateral preferential agreements (in place of absolute most-favoured-nation treatment), and greater consideration was to be given to differences in the state of development in the member countries. On the whole trade liberalization through ALADI was as unsuccessful as the similar attempt by ALALC. Along with the problem of differing levels of development, which if anything was actually strengthened by the discriminating effect of bilateral trade agreements, external shocks were also partly responsible for the failure.

### **Current Efforts at Integration**

Efforts at integration have gained new impetus in Latin America since President Bush suggested a free trade zone from Alaska to Tierra del Fuego in his "Initiative for the Americas" in 1990. The first step in this direction was to

be the adoption of the planned free trade agreement between the USA, Canada and Mexico. The US Congress having given the President the authority to swiftly pursue the negotiations under his own auspices on 1st June 1991, the trilateral negotiations began in mid-June. The trade liberalization is scheduled to begin as early as the end of 1992. After a transitional period, which for the USA and Canada will be from five to ten years, free trade should exist to the greatest possible extent.

In order to create appropriate conditions for the realization of the Bush plan, the Latin American countries have, for their part, increased their integration efforts. On 26th May 1991 Argentina, Brazil, Paraguay and Uruguay agreed to establish a common market in southern Latin America (MERCOSUR), which is broadly modelled on the EC. By way of yearly reductions in tariffs of 20%, all tariffs and non-tariff barriers between the four countries are to be dismantled step-by-step. A deadline of 1st January 1995 has been laid down for Argentina and Brazil, which started reducing tariffs on a bilateral basis in 1986. By 1996, both Uruguay and Paraguay should have removed their trade restrictions. The developing market will be protected by a common external tariff. It is also planned that capital, labour and services should be able to move freely within MERCOSUR. On signing the agreement coordination of the economic policies of the participating countries was agreed. As a preliminary step to realizing the vast free trade zone planned, the USA and the southern bloc of

**Table 1**  
**Economic Integration Groups in Latin America, 1960 – 1980**

Name of integration group	Foundation date	Member countries	Objectives
Latin American Free Trade Association, ALALC (Asociación Latinoamericana de Libre Comercio)	1960	Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Mexico, Paraguay, Peru, Uruguay, Venezuela	To gradually dismantle trade barriers and tariffs, completing the process by the end of 1973 at the latest.
Central American Common Market, MCCA (Mercado Común Centroamericano)	December 1960	Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua.	Dismantling of trade barriers, common external tariff, common industrial policy, currency union.
Andes Group (Grupo Andino)	May 1969	Bolivia, Chile (until 1976), Colombia, Ecuador, Peru, Venezuela (from 1974)	To create a common market, beginning with a free trade area, then a customs union, economic cooperation to accelerate economic growth and reduce dependence upon external factors, a common industrial policy.
Caribbean Common Market, CARICOM	August 1973	Antigua/Barbuda, Bahamas, Barbados, Belize, Dominica, Grenada, Guyana, Jamaica, Montserrat, St. Kitts/Nevis, St. Lucia, St. Vincent and Grenadines, Trinidad and Tobago	Trade liberalization within the group, customs union, economic integration, promotion of industrial development, foreign policy coordination.
Latin American Integration Association, ALADI (Asociación Latinoamericana de Integración)	August 1980	Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Mexico, Paraguay, Peru, Uruguay, Venezuela	Economic cooperation, division of labour, reduction of internal tariffs.

Source: Deutsch-Südamerikanische Bank.

countries within Latin America agreed on 20th June 1991 (in what is known as the "Rose Garden Agreement") to establish a joint committee aimed at fostering trade and investment in the five countries. For other states, in particular Chile and Bolivia, the possibility of joining MERCOSUR has been left open. The problem arises for Bolivia that in joining MERCOSUR it must renounce its membership of the Andes Pact.

On 20th May 1991 the five Andes Pact states (Bolivia, Ecuador, Colombia, Peru and Venezuela) resolved to create a free trade zone in the "Caracas Acts". As early as 1st January 1992, tariffs within this area are intended to be abolished. An exception is planned for Ecuador with an initial tariff reduction of only 50%. The longer-term aim is to establish a customs union. A common external tariff should exist for Colombia, Peru and Venezuela by the end of 1993. Bolivia and Ecuador will have joined this external tariff two years later. In addition, a common internal market should be established by 1995 by coordinating the economic policy of the member states.

Negotiations are also in progress between Colombia, Mexico and Venezuela. In September 1990 these countries agreed in the "Group of Three Accord" to remove all trade barriers by 1995. The deadline has in the meantime been brought forward to July 1994. The question of whether any products will be excluded from the trade liberalization – and if so, which – remains open at present.

Mexico and the five Central American states of Costa Rica, El Salvador, Guatemala, Honduras and Nicaragua would like to have a free trade zone in place by 1996. The agreement signed in January this year permits bilateral trade agreements for individual products during the initial phase.

Also worth mentioning on a bilateral level are the resolutions between both Chile and Mexico, and Chile and Venezuela to cooperate more closely economically.

### Criteria for Success

Whether the current free trade endeavours in Latin America can be successful depends first and foremost on the extent to the economic criteria for that success are fulfilled. Classic customs union theory differentiates between short-term static effects and long-term dynamic effects of trade integration.<sup>2</sup> Short-term positive effects

occur by replacing relatively expensively home-produced goods by cheaper imports from partner countries (trade creation), whilst the reduction of domestic price levels also increases the demand for imports (trade expansion). Once-for-all negative effects occur in the traditional view after the creation of the customs union, when cheap products from the international market are replaced by relatively expensive imports from the partner countries (trade diversion).<sup>3</sup>

More important than the static effects are usually the longer-term dynamic ones. These manifest themselves especially in the improvement of technical and organizational efficiency as a result of increased competition and in the reduction of unit costs by exploiting increasing returns to scale.

Whether and to what extent positive or negative effects occur through trade integration and can also be exploited depends on the following factors:

□ *Number and size of the countries:* The more countries which join together and the bigger they are, i.e. the larger their share of international trade is, the more successful the division of labour should be and the smaller the risk of trade diversion.<sup>4</sup>

□ *The magnitude of trade barriers:* The higher the tariffs and non-tariff barriers are before liberalization, the more serious the inefficiencies from the distorted production structure generally tend to be and the greater the welfare effects of trade liberalization are therefore likely to be. On the other hand, for countries with lower tariffs which enter a customs union, losses of welfare occur, since these countries are forced to adjust to the higher common external tariff. The level of external orientation in the integration group is also decisive. The group will have more prospect of success if its competitiveness is secured on the international market, something which can be achieved in the long term by low trade barriers against third countries and a common export promotion policy.

□ *Transport and transaction costs:* If a customs union is created between countries which lie far apart geographically or if the transport system between neighbouring countries functions badly, it is possible that the positive effects of the trade liberalization will be offset

<sup>2</sup> In principle, the effects of integration brought about by a free trade area whose member countries maintain differing external tariffs vis-à-vis third countries are the same as those stemming from a customs union. Where the two structures are different is that the former does not require the coordination of foreign trade and economic policies to the same degree as the customs union.

<sup>3</sup> Some doubt is often cast upon whether trade diversion really is detrimental to developing countries, by referring to the "infant industry" argument. The formation of a customs union could give these countries the opportunity to achieve, at the regional level, learning effects, thus promoting intra-industrial specialization and ultimately enhancing the region's competitiveness on world markets (cf. R. J. Langhammer and U. Hiemenz, op. cit.).

<sup>4</sup> Cf. W. Molle: *The Economics of European Integration*, Aldershot 1990, p. 99.

by high transport costs.<sup>5</sup> Additional transport costs can occur as a result of inefficient border controls or language barriers.

□ *Level of industrial development and per capita income:* Countries which are relatively advanced industrially may profit more from trade liberalization than countries whose production is concentrated on agricultural or service industries. As well as complementary trade (the exchange of industrial products for primary goods) they can also reap the benefits of intra-industrial specialization.<sup>6</sup> This generally occurs between countries with similar, relatively high per capita income. The higher the level of income, the greater the stock of technical knowledge necessary for the intra-industrial specialization and the greater the exploitation of economies of scale due to the size of the home market.<sup>7</sup> Microeconomically the latter work as natural entry barriers for suppliers from less developed economies. Countries with a relatively low level of industrialization within the free trade area are therefore disadvantaged by trade liberalization, since synergy effects work in favour of the more developed economies. Their surplus capacities are often enough to supply the small markets of relatively underdeveloped countries with industrial products. In order to maintain the competitiveness of the afore-mentioned countries, flexible exchange rates between the integrating countries are necessary at least in the initial stages. Irrespective of which specialization strategies the less heavily industrialized countries pursue, the adjustment costs incurred should be compensated for by financial assistance from the more developed economies.<sup>8</sup>

□ *Production structure:* If the countries participating in trade liberalization have a complementary production structure, the product specialization is generally already so advanced that the advantages of liberalization are likely to be only slight. On the other hand, the trade-creating effects should be all the greater, the harder the products of the two countries have to compete with each other.<sup>9</sup>

□ *Monetary stability:* Trade-creating effects cannot work if they are impeded by distortions in the monetary sector. A

hyperinflationary environment with sharp fluctuations in monthly inflation rates is detrimental to the steady development of foreign trade and therefore also prevents the benefits of trade integration being fully exploited, since predicting costs and conducting trade are rendered more difficult. Something approaching monetary stability among the trade partners is therefore a prerequisite. Differences in inflation must be counteracted by realistic exchange rates. Independently of this, distortions in exchange rates should be avoided, or else the comparative cost differences between the countries will not be properly reflected.

□ *Types of economic system:* The benefits of trade liberalization are the greater, the more flexibly production in the participating countries is able to respond to the new conditions. Apart from the importance of capacity reserves from a static viewpoint, another decisive factor for exploiting dynamic effects of competition is the policy direction taken by a country as regards governing the economic system as a whole. In an economy shaped by interventionism, where investment is directed by state planning, producers are, by the very nature of their situation, unable to respond as fully to new market conditions as they would be in a properly functioning market economy.

### Prospects of Success for Integration

Optimism about the success of the free trade plans is generally high. This is also reflected in the results of the international business cycle survey, "Economic Survey International" (ESI), published in January 1991.<sup>10</sup> Over 400 economic experts from all over the world gave their opinions on the current development of international trade and protectionist moves between and within the international trading blocs. The majority of the experts consulted in Latin America<sup>11</sup> expect increased protectionism on the part of the USA in the next five years, whereas they do not believe that protectionist efforts will increase in Latin America. In the MERCOSUR countries which took part in the survey, Argentina, Brazil and Uruguay, it is almost unanimously feared, however, that the foreign trade of each country will be negatively affected by protectionist measures of its trading partners. These fears do not predominate in Mexico or in the Andes Pact states of Colombia and Venezuela. Indeed, all Latin American countries are equally confident that trade integration will grow within the region and Latin America will, as a whole, become better integrated into international trade.

<sup>5</sup> This has been empirically demonstrated for the two Latin American integrative groups of ALALC and the Andes Pact. Cf. J. C. Brada and J. A. Méndez: *Economic Integration among Developed, Developing and Centrally Planned Economies: A Comparative Analysis*, in: *The Review of Economics and Statistics*, Vol. 57, 1985, pp. 549-556.

<sup>6</sup> These benefits derive particularly from utilizing economies of scale while concentrating on a narrower range of products.

<sup>7</sup> Cf. M. Neumann: *Theoretische Volkswirtschaftslehre*, Vol. II, Munich 1982, p. 272.

<sup>8</sup> Cf. Commission of the European Communities: "Soziales Europa", *Europäische Wirtschaft*, 1990 special issue, Brussels 1991, pp. 80 ff.

<sup>9</sup> Cf. W. Mollé, op. cit.

<sup>10</sup> Cf. D. Brand: *Wachstum des Welthandels schwächt sich ab*, in: *ifo Schnelldienst*, No. 6, 1991.

<sup>11</sup> Argentina, Brazil, Chile, Colombia, Mexico, Uruguay, Venezuela.

This optimism could be derived from the hope that a reduction in protectionist practices will now occur on the basis of the economic policy changes in many Latin American countries after decades of isolation. According to the theory of public choice which describes the process of exerting influence by interest groups, a society can only cope with the misuse of power up to a certain extent. As soon as a critical threshold has been reached, the victims of protectionist and interventionist measures will offer resistance at certain key points by forming a counter-coalition. The higher the losses in competitiveness through protectionism and the more firmly an economy is integrated into the global trade system, the less tolerance, as a rule, it is likely to show towards protectionist measures.<sup>12</sup> An example of this is the case of the Brazilian computer industry which, by means of the Information Technology Bill of 1984, managed to reserve the entire Brazilian computer market for itself. Now the Brazilian motor and textile industries are contending that it is impossible for them to modernize without access to a modern computer industry.

Despite the hope that the general framework for economic activity will improve, it ought to be stressed that there have, as yet, been no serious changes in the power relationships of Latin America.

### **MERCOSUR – Doomed to Failure?**

The realization of MERCOSUR would mean the emergence of a common market, which with its 187 million consumers and a GDP of \$ 455 billion would cover about half of Latin America's entire economic activity.<sup>13</sup> On the basis of the size of this market the trade-creating effects ought to be considerable. The proportion of exports to other MERCOSUR countries has so far only amounted to 7% of the members' total exports.

One can certainly expect that the participating countries will benefit very differently from the welfare gains generated. The two large countries, Argentina and Brazil, together generated \$ 440 billion, or almost 97% of MERCOSUR's GDP. Due to their size, both of these economies rely less on foreign trade than Paraguay and Uruguay (cf. Table 2). The latter two countries are also more open in a regional sense than their two bigger trading partners. Whilst foreign trade with the partner countries of MERCOSUR in Argentina and Brazil currently makes up 2.1% and 0.8% of the GDP respectively, the proportion in Uruguay is 10.9% and in Paraguay 12.5% (cf. Table 3).

Brazil will probably be most affected by the restructuring, since here the level of protection is especially high at present with a maximum import duty of

<sup>12</sup> Cf. V. Curzon Price: Welthandel: Mittel gegen den Protektionismus, in: Wirtschaftswoche, No. 19, 4/1991, pp. 88-93. She draws a comparison between the problems of protectionism and environmental pollution.

<sup>13</sup> Latin America as a whole had a population of 423 million in 1989, and a GNP of \$ 874 billion. See Inter-American Development Bank, Annual Report 1990.

**Table 2**  
**Macroeconomic Indicators for the Planned Free Trade Areas**

	Population 1989 in million	GDP 1989 in \$ million	Per capita income 1989 in \$	Exports 1989 in \$ million	Inflation rate 1990 in %	Level of openness <sup>1</sup> 1989 in %
<b>MERCOSUR</b>						
Argentina	31.9	89,320	2,800	9,567	1,344.0	15
Brazil	147.4	349,928	2,374	34,392	1,795.0	15
Paraguay	4.2	6,523	1,553	1,009	42.5	23
Uruguay	3.1	9,384	3,027	1,599	128.9	30
Total	186.6	455,155	2,439 <sup>a</sup>	46,567		
<b>Andes Pact</b>						
Bolivia	7.1	6,681	941	724	18.0	22
Colombia	31.2	46,894	1,503	5,717	37.0	23
Ecuador	10.3	16,387	1,315	2,354	48.5	26
Peru	21.8	27,119	1,244	3,522	7,500.0	21
Venezuela	19.3	61,065	3,164	12,983	36.5	35
Total	89.7	158,146	1,763 <sup>a</sup>	25,300		
<b>North America – Mexico</b>						
Mexico	86.7	175,568	2,025	23,048	30.2	27
USA	249.4	5,198,194	20,843	363,958	5.4	16
Canada	26.3	560,149	21,298	121,358	4.8	43
Total	362.4	5,933,911	16,374 <sup>a</sup>	508,364		

<sup>a</sup>Average for the group. <sup>1</sup>(Exports + Imports) / GDP.

Source: IMF: International Financial Statistics, Yearbook 1990; Inter-American Development Bank, Annual Report 1990; Central Bank of Paraguay, Central Bank of Uruguay, FIEL, Latin American Monitor; other figures computed by the ifo Institute.

85% (compared with 24% in Argentina and 35% in Uruguay).<sup>14</sup> Argentina will benefit most from the opening of the Brazilian market.<sup>15</sup> Argentina's access to this huge market – Brazil's gross domestic product is four times as high as that of Argentina and the population is 4.6 times as large – means there should be a disproportionately strong increase in its exports. As an initial consequence, the inter-industrial exchange of goods will increase. Argentina specializes more in the production of consumer goods and particularly in the food industry. Brazil on the other hand has the lead in durable manufactures, with the emphasis on the metal processing industries.

Crucial in the distribution of dynamic liberalization effects is the fact that Argentina and Brazil have the

highest level of industrialization within the region. Whilst in each of these economies over 40% of the GDP is generated by the industrial sector, in Paraguay the agricultural sector predominates, whereas in Uruguay it is the service sector (cf. Table 4). Owing to their relative homogeneity in terms of market size, per capita income and degree of industrialization, Argentina and Brazil are best equipped to reap the benefits of intra-industrial specialization. According to an empirical study on the distribution of comparative cost advantages, it is expected that Argentina will specialize more heavily in the production of goods requiring relatively skilled labour inputs, whilst Brazil will export more industrial products which require less qualified labour.<sup>16</sup> Thus it is to be expected that bilateral trade between the two countries, which at present makes up over 40% of the total trade volume of MERCOSUR, will especially profit from trade liberalization. The imbalances in intra-regional trade – which currently exist particularly between both Argentina

<sup>14</sup> Cf. Latin American Monitor, July/August 1990.

<sup>15</sup> According to the estimates made in an empirical study, among a group of six Latin American countries Argentina and Brazil would together account for 90% of the trade creation resulting from liberalization. These positive effects would come to 1.34% of GNP for Argentina, but only 0.45% of GDP for Brazil. Cf. W. Cline: El interés de América Latina en la integración económica, in: Integración latinoamericana, No. 62, Buenos Aires, October 1981.

<sup>16</sup> Cf. D. Chudnovsky and F. Porta: On Argentine-Brazilian economic integration, in: CEPAL Review, No. 39, United Nations 1989.

Table 3

**Trade Flows within the Planned Free Trade Areas, 1989**

**MERCOSUR**

Exports in \$ million from	to	Argentina	Brazil	Paraguay	Uruguay	Total exports	Level of openness within the region <sup>1</sup> (in %)
Argentina		–	702.6	91.3	210.0	1,003.9	2.1
Brazil		710.0	–	323.0	334.0	1,367.0	0.8
Paraguay		46.0	340.5	–	9.3	395.8	12.5
Uruguay		105.5	354.6	8.8	–	468.9	10.9
Total imports		861.5	1,397.7	423.1	553.3	3,235.6	

**Andes Pact**

Exports in \$ million from	to	Bolivia	Colombia	Ecuador	Peru	Venezuela	Total exports	Level of openness within the region <sup>1</sup> (in %)
Bolivia		–	4.2	0.3	45.1	0.4	50.0	1.0
Colombia		2.5	–	52.3	93.3	237.2	385.3	1.7
Ecuador		0.2	46.5	–	138.1	4.8	189.6	1.8
Peru		15.4	100.8	28.8	–	71.1	216.1	2.0
Venezuela		–	267.0	20.0	29.0	–	316.0	1.1
Total imports		18.1	418.5	101.4	305.5	313.5	1,157.0	

**North America – Mexico**

Exports in \$ million from	to	Mexico	USA	Canada	Total exports	Level of openness within the region <sup>1</sup> (in %)
Mexico		–	15,675	602	16,277	23.7
USA		24,969	–	78,266	103,235	3.9
Canada		525	85,305	–	85,830	15.6
Total imports		25,494	100,989	78,868	205,342	

<sup>1</sup> Exports to the region plus imports from the region, relative to GDP.

Source: IMF: Direction of Trade Statistics Yearbook 1990; computation by the ifo Institute.

and Paraguay and Argentina and Uruguay – will probably be aggravated due to Argentina's more favourable starting position. This development could endanger the long-term success of the integration process, if the lower competitiveness of Uruguay and Paraguay is not balanced out by corresponding devaluations in the currencies of these countries or compensatory payments from the bigger partner countries.

For Uruguay, the opportunity presents itself to strengthen its role as the financial and services centre within MERCOSUR. As well as its high concentration on the agricultural sector, the problem arises for Paraguay that approximately 60% of its GDP is generated from smuggling with Argentina and Brazil. As far as the purpose of smuggling into the neighbouring countries was to bypass customs barriers, integration would eliminate one of its main causes. The informal economic sector is therefore likely to shrink, and the formal sector can be expected to grow accordingly.

Another likely source of distortions in intra-regional trade lies in the major differences in inflation rates between the participating countries. At the moment, the hyperinflation in Argentina (1,300% in 1990) and Brazil (1,800%) is perceptibly disrupting the ability to assess prices and conduct foreign trade. Since the exchange rate of the Argentinian austral is currently fixed at 10,000 to the

US dollar, it is not possible to compensate for the sharply fluctuating inflation rates via the exchange rate mechanism. In Brazil too, the exchange rate is determined by official intervention. In both of these hyperinflationary countries, the currencies may well be undervalued as a result of the substantial flight of capital. This reinforces the tendency for Paraguay and Uruguay to be placed at a relative disadvantage by trade liberalization.

As far as government policy on the overall regulatory framework for economic activity is concerned, the economies of all four member countries are characterized, to a greater or lesser degree, by state interventionism and a lack of continuity in economic policy. At the moment, the country with the most elements of the market economy and the most stable economic situation is Paraguay. On that basis, one would expect this to be the place where production would respond most quickly of all to the change in operating conditions and where welfare effects would be relatively high. However, a countervailing factor is that the MERCOSUR contract itself permits government intervention. It is expected that the sectoral agreements planned in the contract between individual branches of industry – which are based on the bilateral Argentinian-Brazilian cooperation agreements of 1986 – will lead to employment and production being controlled on a sectoral basis, and that again would benefit the two big countries the most. This being the case, there would be little scope

**Table 4**  
**Production Structures in the Planned Free Trade Areas**  
The different sectors' share of GDP, 1988 (in %)

	Agriculture	Industrial and mining	Of which: Manufacturing	Services and other
<b>MERCOSUR</b>				
Argentina	13	44	31	44
Brazil	9	43	29	49
Paraguay	30	25	17	46
Uruguay	11	29	24	60
Average for the group	10	42	25	48
<b>Andes Pact</b>				
Bolivia	24	27	17	49
Colombia	19	34	20	47
Ecuador	15	36	21	49
Peru	12	36	24	51
Venezuela	6	36	22	58
Average for the group	12	35	21	53
<b>North America – Mexico</b>				
Mexico	9	35	26	56
USA	2	33	22	65
Canada	4	40	23	56
Average for the group	2	34	24	64

Source: World Bank: World Development Report 1990; computation by the ifo Institute.



left for foreign trade controlled by the allocation mechanism of the market economy.

On the whole, the chances of success for the MERCOSUR plan are not good. The danger that Paraguay and Uruguay will be comparatively disadvantaged by trade liberalization is not really alleviated by the one-year extension these countries have been granted on the period of transition, during which the so-called preferential positions are still valid.<sup>17</sup> The four countries are still a long way from a harmonization of economic, budgetary and fiscal policies on which the realization of a customs union makes certain minimum demands. As long as day-to-day events are dominated by coping with the domestic economic crisis, and the fight against inflation, unemployment and recession is governed by national interests, the ambitious goals are unlikely to be realized.

As early as two months after the contract was signed people began to doubt whether the member countries were taking it at all seriously. Shortly after the creation of MERCOSUR Brazil announced that it was going to buy subsidized meat from the EC, which was tantamount to discrimination against Argentina and Uruguay. Furthermore, the Brazilian president Collor de Mello announced his country would import 700,000 tons of subsidized grain from the USA – an action which led to a major row with Argentina. In mid-May Brazil was reported to have bought 100,000 tons of subsidized meat from the EC. Uruguay's president, Luis Alberto Lacalle, believes he can still say no to MERCOSUR at a later date, if coordinating economic policy with the hyperinflation countries of Argentina and Brazil causes too many difficulties.

#### **Slim Prospects of Success for the Andes Pact**

With 90 million consumers and a GDP of just under \$ 160 billion, the scheduled free trade area for the five Andes Pact states is less than half the size of MERCOSUR. However, since the proportion of exports to other Andes countries has so far only amounted to 4.6% of the total exports from the Andes region, the potential for trade-creating effects is greater.

In the Andes Pact too, there are differences in the size and economic performance of the member countries, although these are not as serious as those in MERCOSUR. As regards openness, both to external trade and within the Pact region, the individual states are relatively homogeneous (cf. Tables 2 and 3). Venezuela's high ratio of total foreign trade turnover to national income is explained by the fact that over three quarters of its

exports are generated by the oil industry which is for the most part internationally oriented.

Of the five countries Venezuela is also the one with the highest per capita income due to its richness of resources. Bolivia has the lowest income level within the group; it also has the smallest economy and is the least industrialized country of the five. In each of the remaining four Andes Pact countries approximately one third of the GDP is generated in the industrial and mining sectors and approximately 20% of this is in manufacturing (see Table 4). Due to the great homogeneity in their economic structures, Colombia, Ecuador, Peru and Venezuela all meet the conditions for specializing more strongly on an intra-industrial basis within the free trade area, although Colombia and Venezuela have the lead in export diversification. In the period from 1987-1989, non-traditional exports experienced a disproportionately large upturn with real growth rates of 9.1% in Colombia and 24.4% in Venezuela.<sup>18</sup>

Ecuador's lower level of industrialization is not the real reason why the "Caracas Acts" have provided for the country to receive preferential treatment in the trade liberalization process. Rather, there is a fear in influential circles that Ecuador's highly protected industrial sector will not withstand the strong competition from the partner countries – especially Venezuela – after the trade barriers are removed.

Over and above that, distortions are bound to occur because of monetary instabilities and the incalculability of current regulative policies in the participating countries. As long as the internal economic problems of Peru, a hyperinflationary country, remain unsolved, participation in a free trade area makes little economic sense. Whether President Fujimori will succeed in leading the country out of crisis by means of stabilization programmes is difficult to foresee at the moment.

Imbalances in intra-regional trade may also be caused by distorted exchange rates. The oil country Venezuela traditionally suffers from an overvalued currency ("Dutch Disease"), and a similar situation exists for the cocaine exporting countries of Bolivia, Colombia and Peru. As a consequence of this it is very likely that even after the removal of trade barriers, intra-regional trade will not adapt itself to the real comparative cost advantages of the participating economies.

Just as in the MERCOSUR countries, the regulatory stance in the Andes Pact members involves state

<sup>17</sup> 960 such preferences are in operation for Uruguay and 450 for Paraguay.

<sup>18</sup> Cf. M. Collins: Latin America, A new litter of cubs?, in: Economic and Financial Prospects, Swiss Bank Corporation, No. 2, 1991.

intervention to varying degrees. The countries which are most market-economy orientated at the moment are probably Bolivia and Colombia. Yet, in the last year, even in Ecuador and Venezuela there has been a greater move towards a market-oriented economic policy. However one should not conclude from this that the resource endowments in the Andes region will necessarily be utilized efficiently in the sense normally applying in a market economy. Like the MERCOSUR contract, the "Caracas Acts" have also allowed for sectoral industrial planning right at the outset. The Acts permit changes in the national lists of products exempt from tariff reductions, in cases where the opening of the market might be considered "too dangerous" for a national industry. The moment this provision is invoked, the planned free trade area among the Andes countries is as doomed to failure as all the previous integration efforts the Andes Pact has made.

#### North American-Mexican Free Trade Area

The realization of the free trade agreement between the USA, Canada and Mexico would mean that a market would arise reaching from the Yukon to Yucatán, dictated by the USA, to which 362 million consumers would have access and which would have a GDP of almost \$6,000 billion. This market would be comparable with the European Community in terms of economic significance, where a GDP of approx. \$6,000 billion is generated, by a population of about 326 million. Since the proportion of world trade accounted for by the North American-Mexican area is over 22%, the positive effects from the removal of trade barriers should be considerable.

As the biggest economy within the region, the USA is the least reliant on foreign trade with its two partner countries. Hitherto the trade in goods with Mexico and Canada has only amounted to 4% of US GDP and to just under one third

of total US exports. On the other hand, with the proportion of its GDP at almost 24% and the proportion of exports at over 70%, Mexico's trade relations with the USA are already very intensive (cf. Table 3). On average, the tariffs which Mexico imposes on imports from the USA are only 4%, whilst the import duty charged by the USA on Mexican products averages 11%.<sup>19</sup> Therefore, it is likely that the USA will be especially severely affected by the restructuring which trade liberalization will bring about.

Since all three countries, viewed quantitatively, are industrialized to a similar degree (cf. Table 4), the advantages of greater inter- and intra-industrial specialization in a market of that size should be enormous. However, due to their high per capita incomes the USA and Canada have a big lead over Mexico in terms of the stock of expertise and their ability to exploit technical economies of scale. Now that the free trade agreement between the two North American countries has come into effect, this lead has been able to develop further over the past two years, since trade-diversionary effects worked to the disadvantage of Mexico.<sup>20</sup> On the other hand, the export diversification of Mexico has achieved considerable progress in recent years.<sup>21</sup>

When trade barriers between North America and Mexico are lifted, it is expected that Mexican production

<sup>19</sup> Cf. Latin American Monitor, Mexico and Brazil, July/August 1990.

<sup>20</sup> For Latin America as a whole, preliminary estimates suggest that the removal of tariff barriers between the USA and Canada alone will lead to the loss of \$170-million-worth of exports to the USA and \$26-million-worth to Canada. Cf. J. A. Castro and S. Marchese: El acuerdo de libre comercio entre Estados Unidos y Canadá y su impacto sobre el comercio de América Latina y el Caribe, UNCTAD Discussion Papers, No. 33, September 1990.

<sup>21</sup> With their real growth rate of 9.1%, Mexico's non-traditional exports increased disproportionately between 1987 and 1989, even though the Mexican peso was revalued by 9.2% during the same period. Cf. M. Collins, op. cit.

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### SUBVENTIONIERUNG IM WELTSCHIFFBAU

The aim of this study, which was conducted for the Federal Ministry for Economic Affairs, is to examine the effects of the various types of subsidies on the structure and the competitive situation of the shipbuilding industry in the most important shipbuilding countries. The results of the subsidies granted are discussed from the points of view of business economics, macroeconomics and the international economy. (Only available in German.)

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will concentrate more heavily on relatively labour-intensive branches of industry due to its labour cost advantages. In bilateral trade between the USA and Mexico, the goods predominantly exchanged at present are in the mechanical engineering and electro-technical fields. The fact that this category of products holds such a prominent position, taking up approximately 35% of total exports to the neighbouring country in each case,<sup>22</sup> is probably only really a reflection of comparative advantage in as far as Mexico has already specialized in the relatively labour-intensive processes within this branch of manufacturing. In the bilateral agreements with which trade liberalization can be expected to begin, Mexico is especially likely to press its partner countries to relax their restrictions on textile imports. The textile industry makes up only 0.7% of Mexican exports to the USA at present.<sup>23</sup> The Mexican agricultural sector, too, stands to make considerable gains from the removal of trade barriers. Mexican exports of vegetables and fruit amount at present to a mere 4% of total exports to the USA. The removal of import duties on these products will run into opposition from the US agricultural lobby, however. Already citrus farmers in Florida fear a loss of 8,700 jobs in their own state alone.<sup>24</sup>

Mexico will also experience positive employment effects since the position of the "maquiladora" industry will change as a result of the free trade zone. These are assembly or contract processing plants which were erected by US firms on Mexican soil close to the border in order to exploit the low labour costs in Mexico. Over the last 25 years, 1,500 such assembly plants have been set up. What this amounts to in effect is an enclave economy in which 97% of the input products are brought in from the USA without any considerable portion of the finished products being sold in Mexico. The creation of the free trade zone would mean that the "maquiladoras" would become regional undertakings and that they would probably purchase inputs from and sell their products to Mexican companies. In addition, a second wave of investment from US and international companies would be triggered off in Mexico's interior rather than near the US-Mexican border as has largely been the case so far.<sup>25</sup>

In Mexico the planned free trade agreement with North America is looked upon positively in general. According to

a survey of 250 of the country's firms carried out in November 1990 by the Mexican economic magazine "Expansión", various other positive stimuli for the economy were expected in addition to trade creation. 87% of the firms questioned believed that free trade with North America would bring improvements in the quality of the goods and services offered, 85% felt that the modernization of the country would be speeded up, and over 60% of the firms each expected increased revenues as well as reductions in prices. More than half of the Mexican firms questioned were against the protection of individual branches of industry within the free trade agreement; nevertheless, 24% expected an increase in unemployment.

There will be a variety of positive effects for the USA too. A study by the University of Maryland came to the conclusion that in the USA 44,500 new jobs would be created within the space of five years, of which the mechanical engineering industry, metal, chemical, and plastics industries and grain producers would profit most. Rüdiger Dornbusch of the Massachusetts Institute of Technology even predicts an increase of 150,000 jobs in those same five years, which can be attributed to an export boom in the areas of electronic components, textiles, steel, vehicles and related products. An improvement in the investment climate in Mexico and a stronger peso also suit the foreign trade policy interests of the USA.

In view of the favourable economic environment, it is unlikely that trade integration will be adversely affected by distortions of a monetary nature at the moment. Although inflation in Mexico rose again from barely 20% in 1989 to 30% in 1990, a renewed fall in the rate is expected for 1991, as a result of further reductions in the budget deficit and the continuation of the stability pact between the government, unions, businesses and farmers' associations.

Conditions in the partner countries are also favourable as regards overall regulatory policy. The free market course embarked upon by Mexico's President Salinas de Gortari, whose main elements are the promotion of private investment, privatization and deregulation, has been written into the national development plan for 1989 to 1994.

On the whole, the chances for the success of the North American-Mexican free trade area can be seen as extremely favourable. However, the speed at which the welfare effects of trade liberalization feed through will depend, first and foremost, on the power of US interest groups from the labour-intensive production sectors, who see their branches of economic activity as being threatened by cheaper imports from Mexico.

<sup>22</sup> Source: The Economist Intelligence Unit, Country Report on Mexico, No. 1, 1991.

<sup>23</sup> However, part of the reason for this is that much of the "maquiladora" industry (see below in the main text) is concentrated on carrying out contract work in the textiles business.

<sup>24</sup> Cf. Latin American Monitor, Mexico and Brazil, May 1991.

<sup>25</sup> Cf. Deutsche Bank Group, Deutsche Gesellschaft für Anlageberatung 1991.