Abstract

The North American Free Trade Agreement (NAFTA) increasingly looks like a "one shot" deal with little of the ongoing deepening of economic relationship expected at the time of its negotiation and no provisions for ongoing negotiations. As a result, alternative-trading arrangements may provide an opportunity to move the North American Trade agenda forward. The Free Trade Area of the Americas (FTAA) is one alternative, however, it is an extremely ambitious undertaking bringing together a large number of very divergent economies in terms of size, stage of economic development, economic performance and economic philosophy. This increases the complexity of negotiations and the probability of failure. The paper outlines the major areas where negotiations are likely to be difficult and provides suggestions regarding what has been learned from the NAFTA experience that is relevant to the FTAA.

Key word: Free Trade, Globalization, NAFTA, FTAA, International Business

Resumen

El Tratado de Libre Comercio de Norte América (ALCA) parece haber logrado sus objetivos sin planes adicionales para continuar negociando otras provisiones para el tratado. Sin embargo, con la intención de seguir avanzando el comercio de Norte América, el nuevo Tratado de Libre Comercio para las Américas o FTAA por sus siglas en ingles, es un acuerdo comercial sumamente ambicioso que entrelaza una amplia cantidad de economías diversas en tamaño, desarrollo, desempeño y filosofía. Esto aumenta su complejidad y también la probabilidad de que fracase. Este documento señala las áreas donde se espera que haya dificultades en las negociaciones y provee sugerencias basadas en lo que se ha aprendido de la experiencia con el ALCA que será relevante para el FTAA.

Palabras clave: Comercio Internacional, Globalización, NAFTA, FTAA, Libre Comercio

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NAFTA and Beyond: Challenges in Free Trade

Introduction

As a political vision, the Free Trade Area of the Americas (FTAA) is bold and inherently appealing. It is the type of initiative with which heads of government can step above the stifling politics of their daily lives, meet and, in fact, state new courses and put bureaucratic wheels in motion towards realizing a vision. Trade agreements are also relatively safe visions because they hinge on a long process of negotiations. The international political scene is full of trade agreements that have proved to be nothing more than mere dreams – particularly in Latin America – but the European Union (EU), the North American Free Trade Agreement (NAFTA), MERCOSUR and a range of lesser agreements in different parts of the world have fundamentally altered the course of economic development in their regions.

Looking past at its political vision, the FTAA is the most ambitious regional trade undertaking ever attempted. It encompasses 34 countries – the multilateral GATT negotiations in 1947 had only 23 signatories. When the GATT came into being on January 1, 1948,

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there were only ten countries that had ratified the agreement (Kerr, 2002). The EU began with only six countries and over its long life has only grown to encompass 15 countries and is currently embroiled in an extremely acrimonious debate about the accession of future members. The NAFTA has only grown from two to three members. The Asia Pacific Economies Cooperation (APEC) is the only major trade agreement that rivals the FTAA for memberships but, so far, it has been far less ambitious in its liberalization agenda than the proposed FTAA (Yeung, et al., 1999).

It seems clear that Latin America is looking for a new economic paradigm that can remove two of the major hindrances to its economic performance, corruption and cronyism, and deliver prosperity without the booms and busts that have become associated with being part of global capital markets. Of course, the economic busts simply represent the rough discipline of the international market for poor economic management (Kerr, 2000) – the real problem is the market's predilection to punish those countries that manage well, but simply happen to be nearby, the *flu* effect, and represents a lack of sophistication among those decisions makers in financial institutions and not an endemic economic management problem in Latin America. In the run up to the FTAA, it is going to be particularly difficult to convince those countries that have suffered from the Argentine flu, and before that the Asia flu, in which the discipline on economic decision making of open markets (Hobbs, et al., 1997) outweighs the costs associated with their lack of sophistication. Of course, the US and Canada remain committed to the open economy paradigm (of course tempered by the political reality to their domestic protectionist interests).

The spirit of free trade has swept through Latin America over the past decade broadly embraced as a much-needed improvement to long-standing closed economic policies though it has produced a confusing patchwork of hemispheric free trade agreements. At present Western Hemisphere countries have either signed or are negotiating over 50 sub regional trade pacts. Looming over all these efforts is the promise of creating the Free Trade Area of the Americas (FTAA) 2005, an agreement that would stretch from northern Canada to the southern tip of Chile and, hopefully, would also tie

together these disparate and sometimes overlapping trade arrangements. Appendix I shows a general overview of the major trade agreements and their provisions.

These developments place the US trade policy squarely at the crossroads of whether or how to proceed formally with the FTAA. Trade policy debates have been contentious in the aftermath of NAFTA and the turbulent fallout from the Mexican peso devaluation in 1994. Also, issues that arose from labor, environmental groups, and import competing industries, which were central to the NAFTA debate, continue to be of concern in the FTAA context.

Different Views on Where to Start Negotiations

Negotiations are taking place over a range of major areas of international trade law; e.g. market access, government procurement, investment and services. At this point, the negotiations are still at the stage of attempting to establish the modalities regarding what will be the starting point for the actual negotiations. Negotiations under some agreed upon modalities are slated to start late in 2002 and the entire agreement is to be wrapped up by January 2005. As yet, there remains no agreement on major modality items except tariffs. The alternatives for tariffs were agreed at a vice-ministerial meeting in Santo Domingo in August 26 – 30, 2002.

While an agreement on tariff modalities is quite understandable, and certainly welcomed, the emphasis on negotiating the reduction of tariffs seems somewhat out of place. Tariff modalities are probably the easiest barrier to international transactions to negotiate because the negotiating parameters are well defined and it is where the human capital of negotiators is strongest. The problem is that tariff reduction is also one of the least important aspects of what needs to be accomplished in a FTAA. The emphasis of the FTAA needs to be placed elsewhere on trade in services, rules for investment, government procurement and other market access issues such as sanitary and phytosanitary policies.

However, negotiations regarding tariffs were, in general terms, however, difficult. The central disagreement was over whether "bound" or "applied" tariffs should be the modality from which tar-

iff offers should commence. World Trade Organization (WTO) bond tariffs are, in many cases, well above those that countries actually apply. The "bound" tariffs are used as the starting point for tariff offers; thus meaning that reductions can be offered given little or no additional market access. It also means that countries bound and applied tariffs are the same, or near to be the same, give larger increases in market access than those countries whose applied and bound tariffs diverge considerably. Even if tariffs are phased down to zero on the long run, those countries with large differences in bound and applied rates are able to delay opening of their markets until later in the phase-in-period. The US, in particular, was insistent that applied tariffs be used as the starting point for tariff offers. The Caricom countries, on the other hand, wanted bound tariffs to be applied in the case of at least some countries as special and differential treatment. In the end, the compromise reached was that applied tariff rates would be the general rule applied but that Caricom counties were granted an exception for the use of WTO bound rates on a limited list of, largely, agricultural products. This concession was secured by stipulating that the applied rates would be those extended on a "most favored nation" basis which, are in many cases higher than the rates actually charged under the "general system of preferences" (GSP) agreements or other preferential arrangements entered into by the US and Canada with developing countries.

In other areas concerning market access, the US insists on other provisions for the FTAA. This may prove contentious in areas such as biotechnology – modified products from their domestic economies.

Unfortunately, the aspects of FTAA negotiations dealing with market access are likely to be much more complex and there are fewer precedents for reaching an agreement. In addition to the negotiating group on market access, there are eight other negotiating groups covering investment, services, government procurement, dispute settlement, agriculture, intellectual property rights, subsidies, antidumping and countervailing duties, and competition policies.

One of the most contentious issues is trade remedies – and in particular US antidumping and countervailing duties' mechanisms. It is well known that the WTO antidumping definitions are based on a fundamentally flawed economic premise (Kerr, 2002a). Furthermore,

the existing domestic US mechanisms for investigating and penalizing dumping and imposing countervailing duties, while WTO compliant, are open for harassment foreign firms and available to extend temporary protection in times of economic downturns. Just for these reasons, they are dear to the hearts of many in the US Congress, primarily because they make it easy to deflect the protectionist pressure. Major trading partners of the US such as Canada have been trying to escape US Trade remedy laws. Canada attempted to have them not applied in the Canada-US Trade Agreement (CUSTA) but was unable to accomplish this goal (Kerr, 2001). Canada did, however, secure agreement in the CUSTA to negotiate a mutually acceptable definition of dumping and countervail able subsidies over seven years. The deadline was, however, removed in the NAFTA negotiations and no progress has been made ever since that time (Kerr, 2001). Canada has tried to use the alternative model approach to show the US that trade arrangements can work without trade remedy provisions. The Canada-Chile Free Trade Agreement exempts parties from dumping and countervailing. In the FTAA negotiations, knowledge of the protectiveness of the US Congress towards trade remedy legislation, countries have suggested much more modest improvements to the WTO provisions for trade remedies. Essentially, the US does not want any limits out on its application of trade remedies, but has agreed to address about the issue under extreme pressure from other western hemisphere countries. The US wants to ensure that other countries' trade remedy procedures are transparent. Furthermore, the US does not want NAFTA-like provisions in the FTAA that would allow for external review of domestic trade remedy findings. All of these issues remain outstanding, thus making it very difficult to reach an agreement on the modalities, much less a final agreement.

The negotiating group on services is over the issue of whether the modality should be a positive list approach as well as a negative list approach. The positive list approach would see markets opened up only for industries that appear on the list. The negative list approach would neither have markets opened up in all industries nor explicitly excluded by being put on the list. The major difference between the two approaches is that under the negative list approach new

service industries would automatically be open to foreign competition. Given that developed countries are the major developers of new services, and they see "the knowledge economy" aspects of services as being a major future source of their competitive advantage, it is probably not surprising that the US favors the negative list approach. Countries such as Brazil, do not want to forgo the opportunity to promote the establishment of domestic service industries in new areas without foreign competition. Furthermore, there has been a discussion as of whether services delivered by foreign firms with a physical presence in the country should be treated using investments provisions, as in NAFTA, or under services as in the WTO's GATTS agreement.

Lessons from the NAFTA

The experience with NAFTA is very important for those negotiating the FTAA. This is so, because of the central role that the US has played in NAFTA and will play in the FTAA. Unlike the European Union, which has been involved in a large number of multilateral trade arrangements, the US until the NAFTA eschewed regional trade agreements, choosing instead to focus on the multilateral GATT. The NAFTA remains the only major regional trade agreement in which the US entered into. It has become involved in less ambitious arrangements such as the APEC and bilateral agreements with some smaller countries. Thus, the US track record in NAFTA provides the sole example for those considering entering into a trading arrangement with the US.

On the whole, the NAFTA experience has been mutually beneficial for all three parties. While the benefits actually arising from trade agreements are almost impossible to assess, because their implementation takes place over very long periods when other forces are inevitably at work, all other things are held constant (Perdikis and Kerr, 1998), the evidence from the NAFTA is fairly conclusive. In addition, there has been virtually no backsliding, all three parties continue to live up to the letter of their NAFTA obligations and there seams to be no wavering on those commitments.

The problem with the NAFTA is what has not happened. The NAFTA was signed with high expectations that it would be the first

step in a long process of deepening economic integration. This was particularly important for the smaller NAFTA partners, Mexico, and Canada. Deepening economic integration is the only way that these countries can protect themselves from the changes in US perspective on international commercial relations. The more deeply integrated the three economies, the more difficult it will be for a government to abrogate an agreement – their own nationals will have too much to lose from a major change in the relationship. Of course, deepening must be accomplished without an unacceptable loss of sovereignty for any of the parties involved and it is clear that the deepening of the economic relationship raises sovereignty concerns among some members of the public, and at times, members of all three governments. The commitment to deepening in the NAFTA, however, was not institutionalized and, in retrospect was rather personally embodied in those who were responsible for fostering the agreement. It seems clear that this was a major mistake. Without institutionalizing the process of deepening, when the fanfare died down the attention of political leaders was drawn elsewhere, the inherent inertia of government bureaucracies and sometimes – over protectionism gained sway (Kerr, 2001). As a result, the NAFTA looks increasingly like a "one shot" deal which, while very beneficial to all three partners, has delivered far less than was initially hoped. It seems clear that the NAFTA's failure to "be all it could be" was the result of inexperience and not purposeful design.

The most obvious failure of the deepening process was the inability to find a satisfactory resolution to the application of trade remedy laws among NAFTA partners. The threat of the application of trade remedy laws as currently structured, which have both untenable economic rationale and mechanisms which are open to harassment (Kerr, 2001), significantly increase the risks associated with conducting transboundary transactions in the NAFTA environment and, hence, inhibits the types of investment that would foster deeper integration of the three economies.

The major institutional problems with the NAFTA are that it has no formal super national body to foster a NAFTA agenda and no automatic provisions for ongoing negotiations. The US, in particular, is suspicious of super national institutions largely because of its

concerns with the limits on sovereignty that they might impose. In the case of the FTAA, it would be more important that the super national body has profile and prestige rather than any actual power to affect sovereignty. If one compares the NAFTA with the European Union, the most striking difference is the absence of the equivalent of the European Commission. Of course, the European Commission has considerable power but it plays an extremely important role beyond that directly related to the power it controls. The Commission is comprised of Commissioners appointed by the Member State's governments. Once appointed, however, the individual commissioners are expected to take an EU perspective rather than to be an advocate for the government that appointed them. By and large, the commissioners have taken on that role – although there have been some notable exceptions.

No one in the NAFTA system is expected to "speak for North America" – one is an American, a Canadian or a Mexican. Of course, all of those that work in the Commission also "speak for Europe". This means that at almost any meeting, conference, policy forum or media event there is someone there to provide a European Union-wide perspective. This does two things; it forces people to consider this broader perspective and respond to keeps it continually in front of them. This helps break down narrow nationalism and gives people a sense of being part of Europe. The cumulative effect of these activities should not be underestimated.

The European Commission is also charged with devising European Union-wide policy proposals. Even if the proposals are rejected by the Council of Ministers or the European Parliament, it means that proposals with such a perspective must be considered. In the NAFTA, there is no institution to play this role; instead, everything must be negotiated by advocates of the individual countries. While the European Commission has admittedly endowed with more political power than would ever be conceded by the US, efficacy in either of these roles is not contingent on an institution having a significant degree of power. The NAFTA has suffered from the absence of this type of institution. Such an institution needs to be created within the FTAA structure. Given the number of countries involved, the FTAA ought to have an organization to oversee and

administer it. It is important that it be structured so as to be able to play a similar role to that of the European Commission even if its power is severely constrained.

Unlike the WTO and the EU, the NAFTA has no mechanisms for ongoing negotiations. This means that it would take a major political effort to launch an initiative designed to promote further deepening of the economic relationship in NAFTA. Furthermore, no agreement will be perfect when written and circumstances will change over time. Without an institutionalized renegotiating provision, it means that it is difficult to correct deficiencies that are discovered and to keep the agreement relevant.

The mechanisms established in the NAFTA to deal with the deepening of the economic relationship through harmonization of standards or the granting of equivalence has not worked. A number of technical committees have been established to accomplish this task in the case of technical standards, sanitary and phytosanitary regulations, among others. However these committees have no mechanism to force a conclusion to their deliberations and, as a result, they have become simply to "talk and talk". For example, since the inception of the Canada US Trade Agreement (the precursor to the NAFTA) more than a decade ago, Canada has been trying to have the grading of beef harmonized – even going so far as to alter its grading standard to match US specifications. The removal of even this minor trade irritant has not yet been achieved largely because of inertia in the US domestic agency that would have to approve it and resistance of a small proportion of the US domestic beef industry (Kerr, 2000). Thus, in the FTAA some mechanism to ensure that such technical negotiations eventually conclude would seem desirable.

Finally, the NAFTA has no mechanism to supervise implementation. Again, to draw on an example from the beef industry, in the original CUSTA negotiations, Canada wanted border inspections for meat is discontinued because there was evidence that these inspections were being used for protectionist purpose (Kerr *et al* 1986). The US agreed that the inspections would no longer take place with the implementation of the agreement. It took years, however, before the provision was acted upon. There was no mechanism in the

NAFTA to ensure that domestic agencies responsible for policy implementation responded to the commitments made in the NAFTA. This is a general problem with trade liberalization when it extends beyond the realm of trade ministries (e.g. administration of tariffs) and into the domain of agencies responsible for domestic policy (Kerr, 2000). At the very least, the FTAA should have a "report card" mechanism where a country's record on implementation can be publicized and moral suasion brought to bear. Again, this would seem to be an appropriate role for a super national institution in the FTAA. The WTO plays this role when it issues its regular assessments of individual country's compliance with WTO provisions.

If the FTAA is to be an agent for the long term deepening of economic integration in the Western Hemisphere, then it must be endowed with the means to move this process forward. Otherwise it will be a "one shot deal" as the NAFTA appears to be. Endowing the FTAA with the opportunity to foster a hemispheric-wide trade liberalization agenda over the long-run cab will likely be accomplished without compromising sovereignty to an unacceptable degree.

Conclusion

The FTAA is a bold vision that runs in the face of almost all of the conventional wisdom regarding either the rationale for regional trade agreements or the likelihood of their success. Regional trade agreements are supposed to be comprised of a small number of countries with similar economies and similar economic philosophies – the FTAA is none of these things. If nothing else, this means that the negotiations will be complex and difficult. The current difficulties in even agreeing to the modalities upon which negotiations will be based underlines the diversity of the countries engaged in the FTAA negotiations. One question that arises is: What is centrally important to the negotiations?

The NAFTA has many of the characteristics of a successful regional trade agreement (but not all of them, given the differences in the level of development between the US and Canada on one side and Mexico on the other). Can the NAFTA experience help focus the FTAA negotiations? At one level, the NAFTA was a great suc-

cess. Its failure is that it has no mechanism embedded within it to move a North American trade liberalization agenda forward over the longer term. It would seem important that the FTAA be endowed with this ability on a hemisphere basis. If the FTAA has institutions that can foster (but not force) a hemispheric trade liberalization agenda on the long run, then the specific provisions agreed in the current negotiations will be less important. Certainly, the initial FTAA must provide ample benefits for all its members to ensure that it is taken seriously, but it is equally important that provisions for ongoing negotiations are included. If done carefully, the FTAA may be able to move the North American liberalization agenda forward in ways the NAFTA cannot.

Glossary

- *CUSTA*- Canada U.S. Trade Agreement
- *Economic Integration* – the integration of commercial and financial activities among countries through the abolishment of economic discrimination.
- *Economic Union* – a group that combines the economic characteristics of a common market with some degree of harmonization of and fiscal policies.
- *European Union* – formerly the European Economic Community, a regional trade pact that includes Belgium, France, Germany, the Netherlands, Portugal, Spain, and the United Kingdom (England, Wales, Northern Ireland, and Scotland).
- *Export* – an entry mode into international markets that relies on domestic production and shipments to foreign markets through sales agents or distributors, foreign sales branches, or foreign sales subsidiaries.
- *Export Restraints* – quantitative restrictions imposed by exporting countries to limit exports to specified foreign markets, usually as up to formal or informal agreements reached with importing countries.
- *Export Subsidies* – any form of government payment that helps an exporter or manufacturing concern to lower its export costs.
- *External Market* – a market for financial securities that are placed outside the borders of the country issuing that currency.
- *Fast Track Negotiating* – authority provided by the U.S. Congress to the Executive Branch to negotiate amendment- proof trade agreement.
- *Foreign Direct Investment (FDI)* – the act of building productive capacity directly in a foreign country.
- *General Agreement on Tariffs and Trade (GATT)* – a worldwide trade agreement designed to reduce tariffs, protect intellectual property, and set up a dispute resolution system. The agreement is overseen by the World Trade Organization (WTO).
- *Freight forwarder* – an independent business that handles export shipment on behalf of the shipper without vested interest in the products. A freight forwarder is a good source of information and

assistance on export regulations and documentation, shipping methods, and foreign import regulations.

- *Market Access* – the extent to which a domestic industry can penetrate a related market in a foreign country. Access can be limited by tariffs or other non-trade barriers.
- *Mercosur* – "Mercado Común del sur" or the "common market of the South", which includes Argentina, Brazil, and Uruguay in a regional trade pact that reduces tariffs on intrapact trade by up to 90 percent.
- *Multinational corporation* – a corporation with operations in more than one country.
- *North American Free Trade Agreement (NAFTA)*– a regional trade pact among the United States, Canada, and Mexico.
- *Tariffs* - a schedule of duties imposed by a government on imported or in some countries' exported goods, a duty or rate of duty imposed in such a schedule, a schedule of rates or charges of a business or a public utility.
- *Trade Balance* – a country's net balance (exports minus imports) on merchandise trade.
- *World Trade Organization (WTO)* – created in 1994 by 121 nations at the Uruguay Round of the General Agreement on Tariffs and Trade (GATT). WTO is responsible for implementation and administration of the trade agreement

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