

**The Case for US Engagement in Latin America:**  
**An Economic Perspective**

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## **EXECUTIVE SUMMARY**

- Latin America's potential for political, economic, and security relations is worth more than present reality.
- A troubled Latin America affects both the security and the economic welfare of the United States.
- Trade is the tool to re-engage Latin America.
- A Regional Trade Agreement between the United States and Latin America will increase welfare throughout the Western Hemisphere.
- Negotiations on the Free Trade Agreement of the Americas (FTAA) are behind schedule, principally as a consequence of the United States' refusal to negotiate its agricultural subsidies at the regional level.
- Failure to re-engage Latin America through trade risks deteriorating democratic institutions and reduce cooperation in important areas, such as the war on drugs and the war on terror.
- Success of FTAA would create reliable allies and increase business opportunities for American companies.
- By unilaterally reforming agricultural protectionism, US consumers and taxpayers will benefit and the logjam in FTAA negotiations will be broken.
- From the US standpoint, the biggest obstacle to free trade with Latin America is farm protectionism.
- From the Latin American standpoint the main obstacles are the protection of intellectual property rights and the freeing of the trade in services and government procurement.
- The main obstacles to the removal of protectionist policies are special interests both in the US and in Latin America.
- Following the blueprint of the EU the current trade-based approach to engagement could be leapfrogged in favor of a much more ambitious scheme premised on institutional convergence.

## The Case for Freer Trade with Latin America

Latin America's potential for political, economic, and security relations is worth more than present reality. Future peace and economic success depends on a stable neighborhood and on more prosperous neighbors – particularly potential economic powers like Brazil and Argentina – increasingly able to trade with the United States.

### Why Latin America Is Important

Except for Europe and some Asian countries such as India, Japan, and the Philippines, no region is as favorably disposed toward democracy and open markets. Compared to the Middle East, where democratic concepts run counter to deeply held cultural and religious traditions that favor authoritarian rule, Latin American leaders have generally aspired to Western-style democracy and markets, as exemplified by numerous constitutions and laws that mirror the US system.

But accountable government and open markets have yet to develop fully because universal rights, free choice, and equal opportunity are still displaced by colonial traditions of government imposed from above, corporatism, and authoritarian personal rule. Meanwhile, failure to encourage the progress of reforms – including free trade – could lead to declining confidence in liberal ideas.

In the background, less democratic powers like China are poised to expand commercial and military influence in the region. If US encouragement for liberal institutions in Latin America wanes, prospects for further expansion of these ideas are even less promising elsewhere in the developing world where the reception is far less favorable.<sup>1</sup>

Additionally, there are good reasons why the US should pay greater attention to threats from the South. At least seven major terrorist organizations have an active presence in the region, including three with ties to transnational Islamic terrorist groups.<sup>2</sup> In 2002, the Brazilian government arrested Hesham al-Tarabili, a suspected agent of al Gama'a al-Islamiya, who is believed to have been involved in the 1997 attack on tourists in Luxor, Egypt.<sup>3</sup> Although Latin America has not been used to launch attacks directly at the United States, it serves as a support base for criminals, illegal armies, and terrorist groups.

According to Ambassador Cofer Black, US Department of State Coordinator for Counterterrorism:

Terrorists in this hemisphere are becoming more active in illicit transnational activities, principally the drug trade, but

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<sup>1</sup> Johnson, Stephen, "Why the U.S. Must Re-Engage in Latin America"

<sup>2</sup> The National Liberation Army (Colombia), Revolutionary Armed Forces of Colombia, and United Self-Defense Forces of Colombia, the Shining Path (Peru), Hamas (transnational Middle East), Hizbollah (transnational Middle East), and the Egyptian Islamic Group (Al-Gama'at al Islamiyya, affiliated with Osama Bin Laden). See US Department of State, *Patterns of Global Terrorism*, pp. 65-74.

<sup>3</sup> *Ibid.*

also arms trafficking, money laundering, contraband smuggling, and document and currency fraud. Not only do these provide sources of income, but terrorists also take advantage of their well-established underground supply routes to move funds, people and arms across borders.<sup>4</sup>

### **Trade: A New Paradigm for US Policy Toward Latin America**

Trade strengthens US allies and engages potential adversaries. Countries with strong trade links never go to war. As Ambassador Zoellick, the US Trade Representative, put it:

Earlier enemies learned that America is the arsenal of democracy; today's enemies will learn that America is the economic engine for freedom, opportunity, and development. To that end, US leadership in promoting the international economic and trading system is vital. Trade is more than about economic efficiency. It promotes the values at the heart of this protracted struggle.<sup>5</sup>

In the post-Cold War era, trade must be the leading edge of US foreign policy. In Latin America, the US must follow the vision of the senior President Bush that trade must be the lens through which the US views its Latin American neighbors.

It is commonplace to decry the absence of US leadership on trade after the passage of NAFTA. Indeed, the disastrous meeting of the World Trade Organization (WTO) in Seattle in 1999 was a terrible failure of US leadership. That failure, however, does not compare to the policy failure of Latin American governments in opening their own economies unilaterally.

Trade helps drive other reforms. Open markets quickly uncover domestic economic policy failures. Firms open to global competition cannot bear the burdens of high tax rates, burdensome regulations, and general government interference in the economy. Official corruption is a tax on economic activity and a depressant on growth.<sup>6</sup> As a result, the government implements reforms that bring prosperity. Firms in emerging markets with a weak rule of law, a corrupt and inefficient judiciary, and ineffective enforcement of property rights will quickly discover that foreign counterparts are unwilling to subject themselves to these problems. The investment flows that typically accompany increased trade flows – and which are often the ultimate objective of trade agreements – will come in trickles, not torrents.<sup>7</sup>

The ancillary consequences of trade opening on a political system were dramatically revealed in Mexico. “In a very real sense, it was NAFTA that brought

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<sup>4</sup> Ambassador Cofer Black, “Remarks to the OAS Inter-American Committee Against Terrorism (CICTE)”, 4<sup>th</sup> Regular Session, Montevideo, Uruguay, January 29, 2004.

<sup>5</sup> Zoellick, Robert B. , “Countering Terror with Trade”, The Washington Post, September 20, 2001, p. A. 35

<sup>6</sup> Chaufen, Alejandro A. and Guzman, Eugenio, “Economic Freedom and Corruption”

<sup>7</sup> English, Philip C. II, and Moore, William T., “Property Rights Ambiguity and the Effect of Foreign Investment Decisions on Firm Value”

Vicente Fox to power because it weakened the grip of the PRI”.<sup>8</sup> The ancillary consequences of keeping markets closed were revealed in Argentina: a protracted recession that ended in economic collapse and political crisis. Just as Mexico exemplifies the positive dynamic of opening markets, the Argentine debacle of 2001-2002 is the paradigmatic case of a closed economy, stalled economic reforms, and political paralysis. Argentina has fallen from being the tenth wealthiest country in the world in 1913 to the 36<sup>th</sup> wealthiest in 1998. Argentina is the only wealthy country to experience such a reversal in modern times.<sup>9</sup> Argentina and Australia were, for much of their history, two Southern Hemisphere countries similar in resource endowment and climate. They tracked each other economically through the 1930s. Institutional differences began to tell over time, however. Particularly in the last 20 years, successive Australian governments have remained committed to economic reform, one hallmark of which has been aggressive tariff liberalization and market openings.<sup>10</sup> Argentina, by contrast, never followed a policy of open markets even in the midst of the reforms of the 1990s. It was and remains a largely closed economy.

The difference in wealth between the countries is due to the different public policies each country has chosen to implement. Capital undoubtedly flies to the safest, most predictable economies. Australia, in this sense, has been rewarded for implementing sound economic policy. By contrast, Argentina – like most other Latin American countries - will continue to suffer until it decides to throw open its markets and strengthen the protection of property. Chile has defied all the conventional policy wisdom by continuing to pursue fairly aggressive unilateral trade liberalization. It has also pursued bilateral trade agreements forcefully, including the recently ratified agreement with the United States.<sup>11</sup>

### **Unfinished Reforms**

Latin American countries have made progress in reforming their economies and improving governance over the last fifteen years. However, half-implemented reforms do not allow full citizen participation in politics or the economy. According to polls, Latin Americans have become increasingly disillusioned with their experiments in democracy and capitalism.

It is in the interest of the United States to help alleviate some of the hemisphere’s problems before they demand attention as the Middle East does. This will entail supporting deeper political and economic reforms, while updating its regional security policy.

Twenty years ago, the United States began to encourage the adoption of democracy and free markets as political and economic models for the Americas and as an alternative both to communist subversion advanced by the Soviet Union and Cuba and to military dictatorship – the prevailing system. This policy helped to defeat insurgencies and to return the militaries to their barracks. Now – with the exception of Cuba - all of

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<sup>8</sup> O’Grady, Mary, “First, Open Markets”, p. 25

<sup>9</sup> Eiras, Ana I. and Schaefer, Brett D., “Argentina’s Economic Crisis: An ‘Absence of Capitalism’”, also *The Financial Times*, March 21, 2001

<sup>10</sup> Hoskins, Lee and Eiras, Ana I., “Property Rights, The Key to Economic Growth”

<sup>11</sup> O’Driscoll, Gerald, “Trade: A New Paradigm for U.S. Policy Toward Latin America”

the countries in the hemisphere hold competitive elections, and most have adopted market economies in principle.

Yet, according to a 2004 Latinobarometro report, only 29 percent of citizens in the 17 Latin American countries say that they are satisfied with democracy – down from 37 percent in 2000. As few as 19 percent have positive feelings about market economies<sup>12</sup>. The reason is that progress has stalled short of allowing full citizen participation in politics or markets.

### **Crony Capitalism**

Despite a trend toward liberalized trade, half of the region is plagued by laws that block competition, leaders that misdirect public funds, and spending programs that are supported by international loans. According to studies like the Index of Economic Freedom, which is published annually by the Heritage Foundation and The Wall Street Journal, many Latin American citizens are barred from fully participating in their own economies by complicated business rules that favor family monopolies, weak property rights, and an absence of the rule of law. Corruption is another factor that keeps wealth in the pockets of those who exercise power.

These days, a Latin American president's first act typically is to travel to Washington to talk with Inter-American Development Bank, International Monetary Fund (IMF), and World Bank officials about refinancing often unsustainable debt. Except in the case of Mexico, which paid off its loans early following its 1995 economic crisis, and of Brazil, which has been adhering to a fiscally responsible policy mix, most borrowers never implement promised reforms and go into even deeper debt to finance structural budget deficits. Absent reforms that challenge existing political monopolies and family businesses protected by corruption or complicated business regulations, such economies can never be self-supporting.

### **Weak State Authority**

The skeletal nature of local government has made Latin America attractive to smugglers and subversive movements since centralized national security forces cannot easily extend state authority throughout the reaches of national territory. South America's Andean ridge supplies most of the cocaine entering the United States, while much of it passes easily through the Caribbean and Central America.

The poorly policed borders of Argentina, Brazil, and Paraguay are home to large immigrant communities of smugglers that are believed to finance Middle Eastern terrorist groups while trading arms for drugs with Colombian guerrillas. Money laundering is an attendant plague that allows drug dealers, arms traffickers, and international crime organizations to disguise illegal proceeds.<sup>13</sup>

### **Putting US-Latin American Policy Back on Track**

Although Latin America has the primary responsibility for its own well-being, its troubles affect the United States. Poor access to political and economic opportunity divides societies and causes instability, which in turn depresses markets. Lack of opportunity displaces desperate populations – often to US borders.

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<sup>13</sup> Johnson, Stephen, "Why the U.S. Must Re-Engage in Latin America"

The United States must articulate its interests clearly and pursue more effective engagement. Otherwise, it will face declining markets for exports as the region's economy contracts, shrinking access to energy resources, more complicated and costly criminal and terrorist threats, and fewer reliable allies in international forums.

Trade is the tool to re-engage Latin America. The United States has an opportunity to lead by unilaterally opening its markets to Latin America's agricultural and labor-intensive exports or by doing so in the context of the negotiation of the Free Trade Agreement of the Americas (FTAA), the initiative for the creation of a single trading area between Alaska and Tierra del Fuego launched a decade ago and which has been making halting progress since.

The next section will attempt to lay out the economic gains from freer trade with Latin America.

## Strategic Trade Policy

Ever since Adam Smith published *The Wealth of Nations* in 1776, the vast majority of economists have accepted the proposition that free trade among nations improves overall economic welfare.

However, although free trade provides overall benefits, it hurts some people, most particularly the shareholders and employees of industries who lose money and jobs because they lose sales to imported goods. Some of the groups that are hurt by foreign competition wield enough political power to obtain protection against imports. Consequently, barriers to trade continue to exist despite their sizable economic costs.

While virtually all economists think free trade is desirable, they differ on how to make the transition from tariffs and quotas to free trade. While the unilateral opening of markets has been traditionally advocated as the approach yielding the most immediate results, the reciprocal approach advocated by policy makers and politicians also has firm grounding in economic theory. Indeed, Bhagwati argued in 1990 that:

“While this [reciprocity] approach is considered ‘mercantilist’ by those who prefer unilateral trade liberalization by oneself, the pairing of mutual concessions has a fourfold advantage:

- i) if I can get you to also liberalize while I liberalize myself, I gain twice over;
- ii) if there are second-best macroeconomic considerations such as short-run balance of payments difficulties from trade liberalization, the mutuality of liberalization should generally diminish them;
- iii) mutuality of concessions suggests fairness and makes adjustments to trade liberalization politically more acceptable by the domestic losers from the change; and
- iv) foreign concessions to one’s exporters create new interests that can counterbalance the interests that oppose one’s own liberalization.”<sup>14</sup>

### Regionalism and the Multilateral Trading System

Regional trade agreements (RTAs) represent an important exception to the WTO’s principle of non-discrimination. According with WTO rules, countries within a RTA can trade among themselves using preferential tariffs and easier market access conditions than what is applicable to other WTO member countries.

In the last few years there has been an enormous proliferation of regional trade agreements across the world. From about 50 in 1990, the number of RTAs notified to the World Trade Organization (WTO) has crossed 250 in 2003. The 2002 WTO annual

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<sup>14</sup> Bhagwati and Patrick, “The Choice between Reciprocity and Unilateral Freeing of Trade”

report points out that currently more than 50 percent of global trade now takes place through the regional trading groups. The scope and geographical reach of RTAs have expanded significantly in recent years. Apart from merely removing tariffs on intra-bloc trade in goods, the newer agreements tend to have deeper coverage. The new generation of RTAs, especially those comprising developed countries, includes more regional rules on investment, competition and standards; as well as provisions on environment and labor.<sup>15</sup>

There is an emerging consensus among economists that frustration with the multilateral trading system is one of the prime reasons behind the current growth in regionalism. Krugman<sup>16</sup> suggests that countries find regionalism an easier alternative because the large numbers of participants in multilateral trade negotiations reduces the cost of non-cooperation and creates rigidity in the system. Also according to Krugman, modern trade barriers are much more complicated to negotiate in a multilateral forum and most countries find it easier to deal with these issues on a bilateral or regional level. In the post Uruguay Round era, and especially in the wake of the Cancun ministerial, the concerns about the multilateral trading system have intensified. Many economists including Bhagwati<sup>17</sup>, Panangariya<sup>18</sup>, and Bergsten<sup>19</sup> believe that the United States' transformation from supporter of multilateralism to a follower of regionalism is another major reason behind the recent growth in regionalism. According to Bhagwati, "*the main driving force for regionalism today is the conversion of the United States, hitherto an abstaining party to Article XXIV*". To support this, it is pointed that the US and the EU are increasingly getting involved in Free Trade Agreements with developing countries on a bilateral or regional level. This has prompted many developing countries to seek participation in Free Trade Agreements with developed countries as a defensive necessity against a possible exclusion from those markets. This creates a bandwagon effect where no country wants to be left out of access to major markets. Baldwin<sup>20</sup> describes a similar motivation for joining regional groupings. However, Baldwin differs with Bhagwati and Panangariya in one important aspect. He does not single out the loss of faith in the multilateral trading system or the US's embracing regionalism as the causes for the resurgence of regionalism. Rather, he feels that "*resurgent regionalism was caused by idiosyncratic events that were multiplied many times over by a domino effect. In particular, the announcement of the US-Mexico FTA created powerful forces for inclusion that led to NAFTA and a sequence of NAFTA membership requests. Since these requests were put off, the forced vented themselves in a series of overlapping bilateral and plurilateral agreements in the Americas. One of them – Mercosur – is generating its own domino effect.*"

### **United States Trade Strategy**

The currents underlying trade liberalization are presently at an interesting juncture – midway through an ambitious round of multilateral trade negotiations, alongside a

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<sup>15</sup> Pal, Parthapratim, "Regional Trade Agreements in a Multilateral Trade regime: An Overview"

<sup>16</sup> Krugman, Paul, "Regionalism versus Multilateralism: Analytical Notes"

<sup>17</sup> Bhagwati, Jagdish, "Regionalism and Multilateralism: An Overview"

<sup>18</sup> Panangariya, A., "The Free Trade Area of the Americas: Good for Latin America?"

<sup>19</sup> Bergsten, C. Fred, "Competitive Liberalization and Global Free Trade: A Vision for the Early 21<sup>st</sup> Century"

<sup>20</sup> Baldwin, Richard E., "A Domino Theory of Regionalism"

renewed frenzy of forging regional agreements. The United States provides one of the starkest representations of this phenomenon, tabling bold proposals at the WTO for global reductions in tariff and nontariff barriers while simultaneously launching discussions for RTAs with partner in the Americas, Africa, the Pacific, and the Middle East.<sup>21</sup>

US Trade Representative Robert Zoellick has argued that RTAs will trigger a “competitive liberalization” which could be an alternative route to free trade as nations compete to open their markets to one another.<sup>22</sup> In particular, he asserted that the fear of being excluded from narrower deals can induce non-member countries to join the group or/and to accept a broader agreement. Thus the belief is that NAFTA preferences in the US market would encourage other countries in the Western Hemisphere to become part of the Free Trade Area of the Americas (FTAA), as the FTAA itself would stimulate a multilateral round of trade liberalization.

According to the “competitive liberalization” strategy, RTAs would continue to expand and to merge until one single RTA encompassing the whole world is left. This is precisely Baldwin’s “domino effect” theory.<sup>23</sup>

The United States has embarked on a new thrust to increase its participation in regional and bilateral trading arrangements over the next few years. Following the longstanding (since 1985) Free Trade Agreement (FTA) with Israel, the United States established an FTA with Canada in 1989 which subsequently evolved into the North American Free Trade Agreement (NAFTA) by including Mexico in 1993. Since then, an FTA was set up with Jordan in 2001, and arrangements with Singapore, Chile, Australia, and the five countries of the Central American Free Trade Agreement (CAFTA) have been signed. The US administration has formally stated its intention to launch FTAs with Morocco, and the members of the Southern African Customs Union (SACU: Botswana, Lesotho, Namibia, South Africa, and Swaziland) before the end of 2004. Negotiations are also continuing to form the Free Trade Area of the Americas (FTAA) with the 33 other democratic nations of the Western Hemisphere by 2005, and a longer-term process is ongoing within the Asia Pacific Economic Cooperation (APEC) forum.

More recently, the US Administration has unveiled the broad outlines of a strategy to enhance trading relations with the Middle East. The key components of this program involve: (a) expanding the US Generalized System of Preferences (GSP) to the poorer countries of the region; (b) assisting Middle Eastern countries which are not yet members of the WTO (such as Saudi Arabia) to join; (c) completing the FTA with Morocco and possibly “docking in” other countries to the treaty; (d) launching new FTAs with selected countries – initially Egypt and Bahrain; and (e) eventual establishment of a free trade agreement between the Middle East countries (as a bloc) and the United States.

For the United States, part of the fresh excitement with forging new bilateral and regional trade ties is linked to geopolitical and security considerations., in which trade agreements are seen as a vehicle for deepening political relationships and/or combating terrorism – a prime consideration in the treaties with the Middle Eastern nations. Free

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<sup>21</sup> Hilaire, Alvin and Yang, Yongzheng, *The United States and the New Regionalism/Bilateralism*

<sup>22</sup> “US, Singapore Near pact on Trade Talks Are First of many Bush Administration Plans to Pursue for Bilateral Deals”. *The Washington Post*, November 20, 2002.

<sup>23</sup> Andriamananjara, Soamiely, “On the Relationship between Preferential Trade Agreements and the Multilateral Trading System”

trade areas are also viewed as helping to increase market access for US exporters by jumping over high trade barriers (e.g., in SACU), as well as countering preferences in other bilateral/regional accords to which the United States is not party, e.g. Mexico/Chile, Canada/Chile, or the various European Union agreements. The Administration has also argued that this approach can complement multilateral trade liberalization by helping to forge common negotiating positions with partners, or compensate for slow progress in these negotiations.

Trade in goods per se, except perhaps in specific sectors, appears not to be a dominant force for the United States. Apart for NAFTA members, US exports to other potential partners are not significant as a share of total exports – less than 3 percent for Australia, Bahrain, Chile, Egypt, Israel, Jordan, Morocco, Singapore, SACU, and CAFTA individually. On the other hand, the partners rely much more on their trading relationship with the United States and the shares of exports to the US market have generally increased over time, for example, to over one third of Israeli exports and about one-half of CAFTA’s exports. Although the US market is not currently a principal destination for Middle Eastern countries’ exports, the jump in the share of Jordan’s exports to the United States from 1 percent to 10 percent between 1997/99 and 2000/02 shows the latent potential for rapid expansion of trade flows under FTAs.

Much of the economic impetus for the FTAs therefore lies outside of merchandise trade. The United States, as the world’s principal exporter of services, has a particular vested interest in market opening in this area. Rules on liberalizing services as well as on such matters as intellectual property rights, the environment, labor standards, and provisions for uninhibited capital transfers are now standard components of the new genre of FTAs. Many of the partners of the United States in fact view the likely stimulus to direct foreign investment as even more critical than market access in goods, especially since their goods may already have preferential entry terms to the United States although on a discretionary basis (such as under the GSP, Caribbean basin Initiative (CBI), and African Growth and Opportunity Act (AGOA)).<sup>24</sup>

The combination of economic, political, and security motivations has clearly been strong enough to drive the pursuit of FTAs with the United States, and there is little discussion now about changing course. In general, trade liberalization on a multilateral basis is preferable to regional/bilateral schemes in avoiding trade diversion and the complications accompanying a large amount of overlapping preferential arrangements. Regional agreements may nonetheless provide helpful opportunities to promote trade liberalization, especially when political and other factors impede unilateral or multilateral approaches. The key to ensuring that these agreements have favorable effects is to strive toward maintaining relatively low external barriers in order to minimize trade diversion. Typically, regional agreements are likely to offer the greatest benefits, and to entail less diversion, if they have the following characteristics:

- They are diverse in regional coverage. Diversity is associated with greater complementarity of trade patterns, and greater trade with advanced countries may bring advantages to developing countries through increase investment flows and technology transfers. This suggests that the benefits of North-South

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<sup>24</sup> Hilaire, Alvin and Yang, Yongzheng, “The United States and the New Regionalism/Bilateralism”

arrangements may exceed those of South-South arrangements (World Bank, 2000).

- They are comprehensive in their coverage of products. FTAs are likely to bear greater fruit if they extend beyond manufactured trade, and include agricultural products and services.<sup>25</sup> Even more benefits can potentially derive from comprehensive approaches that liberalize foreign direct investment, strengthen competition policy, and improve regulatory frameworks. However, the emphasis should be on assisting countries toward these objectives, rather than using the threat of trade sanctions to spur action.
- FTAs may play an important role in helping lock in broader reform agendas among participating countries. For example, FTAs appear to have been helpful in encouraging reforms in the area of investment protection and customs administration. At the same time, however, care is needed to ensure that reforms are consistent and appropriate for countries' stage of development.

### **Conclusion**

The US model for bilateral and regional integration meets many of the criteria for maximizing the potential benefits. In particular, as part of the negotiation of the FTAA, timetables are to be established for removal of all trade restrictions on manufactured goods, agriculture, and services. Hemisphere-wide rules would be established for intellectual property rights, subsidies, antidumping, countervailing duties, government procurement, investment, competition policy, and dispute settlement.

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<sup>25</sup> While many of the existing FTAs have a comprehensive product coverage, agriculture is often given a longer period of transition or largely excluded from liberalization.

## The Dangers of the Status Quo

Today, the Western Hemisphere is divided into competing and overlapping trading blocs. The landscape is not so much Baldwin's "domino effect" as it is Bhagwati's "spaghetti bowl effect", with preferences like noodles criss-crossing all over the place<sup>26</sup>. The North American Free Trade Agreement (NAFTA, signed 1992) between the United States, Canada and Mexico has been expanding, recently including Chile, five Caribbean countries, and is in negotiations with Colombia and Peru. Mercosur (created in 1991), the common market between Brazil, Argentina, Uruguay and Paraguay has recently included Chile and Bolivia as associate members. Additionally, the European Union has been making steady progress in the negotiation of an EU-Mercosur Regional Association Agreement, having already held 13 rounds of negotiations under a negotiating mandate (comparable to fast track authority in the US context).

With the 2005 deadline for concluding the Free Trade Agreement of the Americas (FTAA) fast approaching, it is important to evaluate the relationship between the United States and Latin America. Ostensibly, the 34 democracies of the Western Hemisphere are pursuing a trade agreement that would open up a larger, more diverse market. Consumers and producers are looking to benefit from cheaper inputs and outputs. Moreover, the positive externality of stability that trade ensues provides the opportunity for Latin American countries to develop their still-burgeoning democracies. The sooner a free trade agreement is devised between the United States and its Latin American neighbors, the sooner the region will be bound to a path of economic development and democratic stability. However, with differing interests and a number of preferential trade agreements already in existence, there are varying levels of commitment for pursuing the trade agreement with different standards.

While both the United States and Latin America will benefit economically, there are strong political implications as well. Ensuring a clear path for all member countries, the candor of free trade will guarantee transparency within each country's financial and democratic institutions. This will secure democracy and create a path towards stable economic development, which is in the interest of citizens everywhere.

Presently, however, the United States appears to feel that it has much to lose with the FTAA. Fearing that it may need to negotiate out its agricultural subsidies, the U.S. has all but shelved negotiations. In a Miami meeting during November 2003, FTAA countries agreed to seek a more 'flexible' agreement on trade. This benefited the United States, as it insisted that farm subsidy discussions be postponed and discussed at the WTO, on a multilateral level.<sup>27</sup> However, Brazil was quick to retaliate, threatening that, as long as the United States refused to discuss agricultural subsidies, Brazil would postpone talks on trade in service industries, intellectual property rights, and government procurement. This retaliation postponed regional discussions.

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<sup>26</sup> Bhagwati, Jagdish, Testimony – Subcommittee on Domestic and International Monetary Policy, Trade and Technology, April 1, 2003.

<sup>27</sup> On July 30, 2004, the U.S., EU, Brazil, India and Australia met and agreed to remove export subsidies and reduce other farm subsidies. This rescued the Doha round of multilateral talks, but details remain to be negotiated.

Instead, the United States has been pursuing bilateral agreements that pose little or no competitive threat to American producers. Mexico (under NAFTA), Chile, and five Central American countries have signed or are about to sign free trade agreements (FTAs) with the United States. Half a dozen other countries, including Colombia and Peru, eagerly signed up to negotiate even more FTAs, showing a shift within Latin America to pursue bilateral trade agreements over the regional initiative. However, U.S. commitment to the promotion of free and fair trade in the Western Hemisphere is being questioned.

As in all negotiations, each country has to be willing to make hard sacrifices to ensure fair trade, credibility, and the strength of the trade agreement. Without willingness to concede in certain areas, negotiating partners will retract and be less enthusiastic about the prospects of free trade. This is why the United States must unilaterally decide that maintaining agricultural subsidies has trade diverting effects that hinder the fair negotiation of the FTAA. This in turn hurts consumers and investors at home, impeding the rational democratic and economic development of Latin American neighbors. The United States Congress must act fast. Already, South American countries are voicing their concerns regarding American commitment to free and fair trade. Regional negotiations are being shelved, much to the expense of American interests in pursuing intellectual property rights, trade in services, and government procurement. Propelled by the growing momentum of Brazilian leadership, this movement is gaining force and will soon be an important counterweight against the United States. At this point it is impossible to meet the January 1, 2005 deadline for concluding negotiations. The United States must retake a leadership role in negotiations.

### **The US Agenda and American interests in FTAA**

Despite recent detachment, the United States has consistently had an agenda for Latin America. Generally, the agenda has been threefold: 1) to promote democratic politics and responsible governance, 2) to strengthen market economics and promote free trade and investment arrangements, and 3) to bolster security and cooperation in common problems such as terrorism, drug trafficking, and threats to constitutional rule.<sup>28</sup> The Free Trade Area of the Americas represents the opportunity for the three goals to become permanently imbedded into law and practice through regional cooperation. The United States must embrace this opportunity.

The advantages of democratic society are numerous at home and abroad, but many Latin American countries have been unable to benefit from this because of lack of proper incentives to bolster appropriate institutions. The FTAA will provide the motivation for creating and, more importantly, maintaining democratic rule. Even Adam Smith noticed the positive externality commerce has on “order and good government.”<sup>29</sup> The most important institution to be fostered by free trade is the *rule of law*.<sup>30</sup> For Latin America this means an end to corruption and the breaching of contracts. Greater transparency in legal matters will plant the seeds for the prosperity of Latin American democracy. Coupled with an advanced banking and financial system, this would create greater opportunities for investment at lower risk. Moreover, the end to social unrest

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<sup>28</sup> Reich, Otto

<sup>29</sup> As quoted in Eiras, Ana Isabel, “Why America needs to Support Free Trade”

<sup>30</sup> Eiras, Ana Isabel, “Why America needs to Support Free Trade”

caused by failures of democracy will displace violence directed towards the United States. Instead, it will create an area willing to participate in world affairs, such as the war against terrorism and the war on drugs. As these overbearing threats continue to endanger American society, it is important to gain allies not only in words, but allies willing and able to participate in world affairs. For this, allies must be economically strong and sound, and must have a stake in the continued economic prosperity of the United States.

If soundly structured, a FTAA will foster economic growth throughout Latin America. Free trade, as mentioned above, encourages the development of institutions favorable for economic growth. International commerce will reduce the inflationary pressures and open restrictive banking systems that plague Latin America.<sup>31</sup> As foreign and domestic investment increase due to the prospects of a more foreseeable future, increases in demand of goods and services will boost more prospective business growth, which is encouraged by access to different and diverse markets. Data presented by the Heritage Foundation/Wall Street Journal in the *Index of Economic Freedom* shows that countries that open their markets grow at a faster pace than countries that maintain relatively closed markets.<sup>32</sup> A strong Latin America means a strong America, willing and able to fight against global problems such as terrorism and drugs. Furthermore, an economically sound Latin America mitigates the temptation of its citizens to fall into acts of destruction, let it be taken upon themselves, upon their society, or upon the rest of the world.

As democratic stability promotes economic growth, economic stability promotes peace and cooperation with neighboring countries. Once economic freedom is achieved, and the standard of living improves, it becomes rational to want to maintain this level of freedom to preserve the improved life.<sup>33</sup> Contrary to this, oppressed and closed countries often suffer social crises, and its citizens increasingly look with contempt at its better off neighbors. With the FTAA, Latin America's living standards will begin to converge to North America's level, and resentment levels will fall, decreasing insecurity threats. In addition, countries will seek to stop impediments and threats to their own growth. Eradication of the illegal drug trade and terrorism will become top priorities on government agendas, and governments will align with the United States for mutual support.

It is clear that advancement in the FTAA parallels American interests in Latin America. Progress in pursuing the agreement strengthens democratic and market institutions in all participating countries, creating an environment of cooperation on common problems such as the war on drugs and the war on terror. However, the United States appears to be increasingly detached from Latin America. Ironically, in a time when allies are scarce, the United States continues to ignore the potential allies to its south. The United States must agree to negotiate its position on agricultural farm subsidies, regain credibility, and gain allies. But first, we must understand why the United States has been increasingly uncommitted to Latin America.

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<sup>31</sup> Brazil in the 1980s, plagued with a closed economy and income indexation, suffered general increases in prices brought on by lack of competition and increases in prices due to prospective increases in income.

<sup>32</sup> Eiras, Ana Isabel.

<sup>33</sup> Eiras, Ana Isabel.

## **USA and Latin America: Struggle to Commit**

At the onset of the administration of George W. Bush, talks between Latin America and the United States seemed to be prosperous, and U.S. foreign economic policy was that of pursuing free trade agreements throughout the world. However, a war on terrorism and an economic downturn have weakened this commitment. With steel tariffs, textile quotas, and agricultural subsidies all at a higher level, the United States began pursuing unilateral policies of trade discrimination. The failure to continue with the momentum of trade liberalization harmed and continues to harm the American economy.

The reversal of the prospective U.S.-Latin American relations was epitomized by the days of and following Mexican President Vicente Fox's invitation to the White House. While President Bush proclaimed that there was no relationship more important to him than that of its neighbor to the south, the September 11<sup>th</sup> attacks, just a few days later, placed Afghanistan and Iraq on the top of the list of priorities for the administration. Propelled by national pride induced by the War on Terror, special-interest lobby groups took the opportunity to pass off subsidies, tariffs, and other forms of protectionism as a form of patriotism. Protectionist legislation, in turn, alienated American consumers as well as potential allies.

Whether American protectionism was initiated from a misguided exploitation of patriotic feelings or otherwise, hesitation towards a regional agreement became evident. To Latin Americans, American apprehension in regional talks is a sign of threatening unilateralism; a sign that the United States does not want to cooperate, it only wants to take. The United States has instead promoted bilateral agreements with Latin American counterparts in order to avoid regional negotiations.

Bilateral trade agreements favor the U.S. special interest groups because their representatives will always be the negotiating 'heavyweight'. Large countries, such as Brazil, which were uniting with smaller countries and taking a tougher stance on American terms of free trade, were thus left out. Attempting to maintain the status quo of American leadership, the U.S. is alienating specific countries. The alienation of specific countries is no better than alienating an entire region. Moreover, the United States is only maintaining this position to entertain lobby groups that inflict losses on the rest of the American population. Not only does this cause economic loss at home, but it precipitates the loss of allies by dividing Latin America in two: countries participating in FTAs with the United States, and countries who do not. Instead of creating unfriendly borders in Latin America, the United States should promote the region's unity so that it can prosper. Failure in regional negotiations will prove adverse to democratic prosperity and economic growth, nourishing anti-Americanism and threatening the American way of life.

## **FTAA failure: Negative Effect on the United States**

Due to the influence of agricultural lobby groups in deciding terms of free trade, regional negotiations between the United States and Latin America are dying down, at the expense of the majority of the population in the Western Hemisphere. For this reason, it is important to evaluate the negative effects an alienated Latin America will have on the United States. Although the negative effects that the interest groups have on their own population are also considerable, these will be discussed in a later section. In terms of

Latin America, weakened democracies and financial crises give rise to anti-Americanism, mitigating American opportunity to invest, and increasing the possibility of organized attacks on American companies and citizens. To diminish the possibility of this becoming a reality, the United States should push through with FTAA negotiations.

Unfortunately for Latin America, specific crises, either political or economic, tend to have spillover effects to neighboring countries and throughout Latin American society. Failure of democracy gives rise to dangerous anti-Americanism and populist leaders that withdraw from the international political scene. Precariously isolated, they put relations with the United States at an antagonistic level and can potentially become breeding ground for threatening activity. As Moisés Naim, editor of *Foreign Policy*, notes, U.S. disentanglement from troubled regions is costly and dangerous. He cites the importance of keeping elected leaders in Latin America in power to be able to finish their terms and promote the institution of democracy.<sup>34</sup> Loss of allies, as occurred with the overthrow of Bolivian president Gonzalo Sánchez de Lozada in 2003, opens a new breeding ground for anti-American activity. Similarly, this has adverse effects on cooperation of what should be common goals, such as the eradication of illegal drug trafficking.

Latin America is a region that has long been threatened by terrorism and that has involuntarily harbored it. Colombia struggles with a civil war against FARC (Revolutionary Armed Forces of Colombia) and ELN (National Liberation Army) due to weak and corrupt governments. With anti-Americanism imbedded in their beliefs, these groups are known to have cooperated with international terrorist organizations and are increasing threats to American security. Free trade is the best defense against the causes of the existence of these threatening groups, as it would promote the strengthening of democratic institutions and the improvement of living standards, thus diminishing the frustration that leads to this extremism. Similarly, the tri-border region (Brazil, Argentina Paraguay) is a base for Islamic terrorist groups in South America. Groups organized in this area are suspected to have connections with Hizbollah and Islamic Jihad, terrorist organizations that have masterminded attacks in Argentina, Israel, and against the United States.<sup>35</sup> Beyond being a center for organization, the Latin American banking system can work as a tool for money laundering, with top terrorist groups depositing money that is used to fund attacks.

In addition to the above security threats, an unstable Latin America poses an economic threat to American interests. Highly leveraged Latin American countries present a risk for American bondholders, bondholding institutions, and the international financial institutions (IFIs) that are important for providing credibility to those countries' macroeconomic policies. Economies in recession and countries with volatile political leaders are less willing to cooperate with international institutions and repay debts. As a relapse of Argentina's financial crisis in 2001, US investors and bondholders are struggling to be repaid a fraction of the original face value of the defaulted bonds. A default on Brazil's public debt- an event with non-trivial probability- would inflict even greater damage on the United States, the IFIs where the U.S. is a major shareholder, and strategic allies of the United States. Venezuela, which is the source for over 13% of U.S. oil imports, is threatened by political and economic instability. Bringing Latin American countries closer to the United States in the FTAA will promote much the same stability

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<sup>34</sup> Naim, Moises. "Saving Latin America" *Foreign Policy*.

<sup>35</sup> 1983 bombing of US barracks in Beirut, 1992 bombing of Israeli Embassy in Buenos Aires

and creditworthiness that benefited Mexico after NAFTA, curbing potentially threatening activity.

Meanwhile, if the United States and Latin America continue on separate courses, economic and political divergence will continue, creating a danger in the American neighborhood. While it is true that we live in an ‘airplane society’ and that distant countries pose as much of a threat as bordering ones, Latin America poses a different threat to the United States. As we have seen, it can be an additional center for masterminding terrorist activity and harboring threatening elements. Moreover, divergence in living standards contributes to illegal activity across the adjoining borders. This can range from threatening activity such as terrorism, to economically detrimental practices such as illegal immigration and the illegal transport of goods. With a fast growing population coupled with sluggish economic growth, these practices are likely to continue until living standards begin to converge. The economic and social burdens of higher formal unemployment and more people without health insurance will fall on the government. To avoid this from happening, it is important for the government to act now to promote the Free Trade Area of the Americas, thus providing numerous growth opportunities not only for Latin America, but for the United States as well.

### **FTAA: Numerous Growth Opportunities for the United States**

The United States’ interests in quick approval of the FTAA goes beyond the fulfillment of the agenda and hindering the progression of potential security threats. The implementation of the hemispheric free trade area opens the opportunity for the United States to further modernize its economy and it leads the way to attractive investment opportunities.

The modernization of the American economy results from increased competition in certain sectors and an increased demand for employment in technically advanced jobs. Free trade encourages countries to specialize in areas in which they have a comparative advantage in production. The United States’ persistent dominance in advanced and innovative sectors, such as technology and financial services, leads to expanding these sectors. As Professor Stephen Coelen of the Massachusetts Institute for Social and Economic research concluded, “the shift in jobs caused by more open trade places a greater emphasis in the U.S. on higher paying and more technically advanced jobs.”<sup>36</sup> Contrary to popular belief, however, this will not put an end to the traditional agricultural sector.

Many U.S. agricultural products are highly competitive throughout the world. Yield per acre for wheat and corn, for example, exceed efficiency levels anywhere else in the world. However, products such as sugar and peanuts, which are heavily subsidized and highly inefficient, will face difficulty if they do not modernize and lower the cost of production. Unlike US steel, which needed only a few months to modernize and face international competition, subsidies for certain agricultural products have been in place for over 20 years, costing American consumers and tax payers millions of dollars. Once these are removed, artificially high prices for selected agricultural products will decrease to world levels, and tax burden will decrease, increasing American purchasing power.

Moreover, Latin America provides a large market for American goods. With the positive externalities (eg. democracy, financial stability) of free trade properly in place,

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<sup>36</sup> Coele, Stephen P., “The Importance of Latin America to U.S. International Trade”

more confident and wealthier Latin American consumers will demand more of all goods, including knowledge-intensive products and services. Already, 52% of Latin American imports fall into the categories of transportation equipment, medical equipment, electrical equipment, and other miscellaneous manufactured articles, main exports for the United States.<sup>37</sup> As specialization gains momentum and the elimination of trade barriers continues, economies of scale (such as those that produce manufactured goods) will increase, resulting in efficiency gains and lower pressure on domestic prices. Beyond lower pressure on prices, increased specialization and efficiency gains, Latin America is also a large market for American investment.

As the Free Trade Agreement of the Americas comes into effect, American investors will find themselves in an increasingly advantageous position. Lower tariff levels and fewer non-tariff barriers for participating countries means that U.S. trade and investment into Latin America will be favored relative to European and Asian competitors.<sup>38</sup> As statistics show, there is large room for improvement. While Latin America is one of the fastest growing regions, American trade and investment has disproportionately been concentrated with Mexico (because of NAFTA). Mexico accounts for 11.9% of US trade, while the rest of Latin America accounts for only 6.6%. As of now, however, the Foreign Corrupt Practices Act (FCPA) puts American investors at a disadvantage compared to European investors. The EU has repeatedly snubbed passing similar legislation prohibiting questionable business acts, so the United States must promote reforms within Latin America to regain a fair position. By promoting free trade, political and economic processes will demand efficient, and therefore transparent deals, diminishing corrupt practices. For the United States this means opening up many opportunities for investment and growth. However, FTAA negotiations must be pushed forward so that the U.S. can gain access to this market before opportunities are lost.

### **Congress Must Act Now**

With the deadline for the finalization of FTAA negotiations approaching in January 2005, it is important for Congress to pass legislation endorsing regional trade negotiations. Within the stipulations must be the permission to rewrite the Farm Bill, signed into legislation in May 2002. This legislation is the primary point of contention between the United States and the rest of Latin America, as it closes much of the agricultural sector from international competition and it indirectly subsidizes agricultural exports. If the United States Congress does not rewrite this bill, it is going to become threatened with the impossibility of signing a free trade agreement, losing access to important expansion markets. Moreover, the longer negotiations are stalled, the more time countries are going to avoid making reforms.<sup>39</sup> This postponement, known as the 'reciprocity trap', discourages countries from making reforms in order to have more to bring to the negotiating table.

Already, Brazil is taking a tougher stance against the United States in negotiations, disallowing for certain concessions unless its partners cooperate on agricultural issues. Many other Latin American countries are following suit. If the

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<sup>37</sup> Scandizzo, Stefania. *Latin American Merchandise Trade and U.S. Barriers*

<sup>38</sup> Gouvea, Raul. "Brazil and Mexico- Partners in Sowing a Free Trade Area of the Americas."

<sup>39</sup> O'Driscoll, Gerald P. Trade: A New Paradigm for US Policy Toward Latin America. The Heritage Foundation: Heritage Lectures. December 2001.

United States does not retain a leadership role, it will lose negotiating leverage over important issues such as intellectual property rights (IPR), trades in services, and investment protection. The United States must take a more progressive approach to agricultural subsidies to ensure free and fair trade throughout the Western Hemisphere.

The Farm Bill embodies a retreat from free trade. Beyond introducing trade-distorting subsidies and pricing schemes, the Farm Bill is the result of special-interest legislation, with few members of society benefiting at a cost to the majority of the population. The estimate by the Congressional Budget Office is that it will cost \$171 billion over 10 years, but due to poor forecasting and technical errors, the actual spending will be nearly twice as high. The average American family will pay an extra \$4,400 until 2012 due to taxes and higher food prices. Price supports on sugar costs consumers \$1.9 billion per year, while peanuts prices are double the world price and milk prices are artificially inflated by 20 cents a gallon.<sup>40</sup> All of these supports are regressive forms of income distribution, as they disproportionately fall on America's poor, who spend a higher percentage of their income on food essentials. Discontinuing these farm support programs will benefit the United States because it will increase the standard of living for the majority of Americans, not only through more accessible food prices, but also because it is an essential step in opening trade in the western hemisphere.

The reason many Latin American countries are opposed to agricultural subsidies in the United States is because they divert trade from their own products, which are also competitive in the world market. Argentina and Brazil, large agricultural exporters, are expected to suffer yearly losses of \$1.4 billion and \$2.4 billion, respectively, due to distortions in international prices caused by U.S. subsidies.<sup>41</sup> Proportionally, the effect on small Caribbean nations would be very positive if they were given free access to the American market in sugar, cocoa, and peanuts. Instead, the subsidies question American motivations for the FTAA, as legislation passed with agricultural subsidies does not ensure neither free nor fair trade. Increasingly, Latin American nations have begun questioning the United States' leadership position, and are taking an offensive stance that decreases the probability of the success of negotiations. The United States must show willingness to yield its position. Thus, it will ensure legislation that promotes increasing cooperation in the Western Hemisphere.

As long as the United States rebuffs regional negotiations on agricultural subsidies, Brazil will continue to gain momentum in building a counterweight in promoting Latin American interests. Although all countries are interested in the promotion of democracy and free trade throughout the hemisphere, it is in the best interest of Brazil and other Latin American countries to delay negotiations on intellectual property rights, investment protection, and market access for some services. This too hinders the promotion of free and fair trade, but it is a position easily negotiated if the U.S. were to abandon agricultural protectionist policies. This is in the best interest of the United States, as exports are increasingly made up of goods and services that require the imposition of intellectual policy legislation to be successful.

With American inflexibility on this issue, the power vacuum created was filled by Brazil, which has already begun the promotion of a free trade agreement in South America that excludes the United States. Potentially trade-diverting but realistically

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<sup>40</sup> Riedl, Brian M.

<sup>41</sup> "Argentina, Brazil Plan Joint Action Against U.S. Farm Subsidies"

unlikely to come into being, the South American Free Trade Agreement is a sign to the United States that its neighbors to the south are eager to negotiate free trade, but on fair terms. Brazil has long been pushing for Latin American unity, and is now seen as a viable counterweight to American hegemony. With this movement gaining momentum, it is important for the United States to announce that it is willing to negotiate its position on farm subsidies, thus restoring the country's credibility to free and fair trade and reaffirming its position as a leader in the western hemisphere.

### **Conclusion**

In the best interest of all potential FTAA members, the United States must unilaterally decide to reform farm subsidies, thus ending the reciprocity trap. By doing this, Latin American countries will be willing to make reforms and accept the FTAA. Without these reforms, the United States will lose out on extensive opportunities for investment and providing Latin America with a framework for democratic and economic prosperity. Moreover, with the agricultural issue settled, Brazil and other Latin American countries will no longer be able to postpone discussions on intellectual property rights and trade in services, conditions necessary for American growth.

Unilateral reforms favor the U.S. because they increase motivation for the FTAA among all of Latin America. With access to the large American market, Latin American countries will be more willing to make concessions. Regional participation and extensive access to trade and investment will be enough to boost economies of scale production, providing cheaper and more efficient goods, while fortifying democratic and financial institutions. The United States must act now. Disgruntled with FTAA negotiations, Mercosur countries are actively seeking expanding their trade relationship with the EU, which could potentially divert demand of U.S. exports. While the U.S. is pursuing a number of bilateral agreements with Latin American countries (including Panama, Colombia and Peru), these will take away from regional cooperation, diminishing the benefits of free trade. The road to free trade starts with the abolition of trade-distorting subsidies on agriculture. With that, the Western Hemisphere can prioritize cooperation, promoting economic success and political stability throughout the region.

## Obstacles to Freer United States – Latin America Trade

After decades of disappointing results from Import Substitution Industrialization (ISI) policies, many Latin American countries began implementing significant trade liberalization reforms in the 1980s and 90s. Average tariff rates were slashed and the incidence of non tariff barriers greatly reduced. However, the region must further liberalize its trade in order to take advantage of the benefits that freedom of movement of goods and services can provide. Today, with the help of the United States, further trade liberalization continues through bilateral, regional, and multinational negotiations and agreements.<sup>42</sup>

Liberalization in Latin America was accompanied by increased liberalization in the United States. Following the global trends embodied in NAFTA, other FTAs and the Uruguay and Doha rounds, the entire Western Hemisphere began to engage in freer trade. Despite these accomplishments, however, significant barriers to market access remain. In both the United States and Latin America these barriers often affect agricultural products and labor-intensive manufactures, where developing countries tend to have a comparative advantage.<sup>43</sup>

For Latin America, US trade barriers are of particular importance, given the predominant role played by the US in regional trade and the large potential market it represents. Although the US economy remains one of the most open in the world, significant barriers to trade persist. Unfortunately, it is these barriers that most affect the developing economies in Latin America and that hinder the region from further trade reform.<sup>44</sup>

### US Trade Policy

The US is one of the world's most open economies, with an average most favored nation tariff of 5.4%. However, the US maintains restrictions on many products, among which dairy products, animal feed, chocolate, some beers and wines, cotton, peanuts, syrup, molasses, cheese, wheat, sugar, textiles, and apparel are the most notable.<sup>45</sup> Furthermore, the US makes aggressive and unfair use of unilateral trade retaliation and of different forms of non-tariff barriers. Despite ostensibly low tariffs to encourage free trade, the US tariff regime is characterized by tariff peaks and tariff escalation that are impediments to growth for potential exporters abroad, harmful to consumers at home, and market distorting in terms of supply and pricing.<sup>46</sup>

Tariffs above 15% are referred to as *peaks*. Approximately 6% of US tariff lines (311 out of 5,000) are above 15%. Tariff peaks are found in the following sectors: a) basic agriculture, particularly meat, sugar, milk and its derivatives, cereals, tobacco, and cotton; b) fruit legumes, vegetables, and fish; c) the food industry; d) textile products and clothing; e) footwear, leather, and items for travel; f) the automotive area, transportation equipment, and electronic products. In the case of agriculture, peaks may reach 173% (vs.

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<sup>42</sup> Scandizzo, Stefania, "Latin American Merchandise Trade and U.S. Trade Barriers"

<sup>43</sup> Scandizzo, Stefania

<sup>44</sup> Scandizzo, Stefania

<sup>45</sup> Scandizzo, Stefania

<sup>46</sup> Scandizzo, Stefania

a mean tariff of 5.9%), and in the case of food products peaks may reach 350% (vs. a mean of 13.3%).<sup>47</sup> Many of these peaks are in industries that are trivial to US total exports. However, the peaks in sugar, milk, agriculture, and cotton represent industries that are more efficiently and more cheaply performed abroad. Eliminating or lowering these peaks would significantly lower prices for consumers at home, while simultaneously benefiting impoverished producers abroad and mending international cooperation.

*Tariff escalation* refers to tariffs that increase with the level of processing of a product. It is particularly present in agriculture, metals, textiles and clothing, and wood products.<sup>48</sup>

*Non-tariff barriers* (NTBs) are a variety of trade distorting practices, including import quotas, antidumping measures, subsidies, licenses, and labeling, certification and technical requirements.

The Uruguay Round contributed to a sharp decrease in non-tariff barriers, transforming them into tariffs when their complete elimination was not possible. In some cases, however, *Dirty Tariffication* (the practice of setting tariff equivalents that are higher than the equivalent of previous non-tariff protectionist measures) became prevalent, diminishing potential benefits of free trade. While more prevalent in Europe, in the US dirty tariffication has affected sugar and dairy imports. As a result, consumers in the United States pay a significantly higher price for these products than the world market price.

Agricultural imports into the United States are often subject to *tariff-rate quotas*, meaning that the tariff rises once a certain quota is exceeded. Examples of goods with tariff-rate quotas are: beef, dairy products, peanuts, sugar, cocoa powder, chocolate, infant formula, mixes and doughs, condiments, olives, animal feed, tobacco, and cotton. Because many of these are food essentials, the higher prices that result from the tariff-rate quotas disproportionately affect poorer citizens that spend a higher percentage of their income on these goods. Approximately 75% of primary products and manufactured goods of agricultural-livestock origin and 25% of manufactured goods of industrial origin are affected by some sort of non-tariff barrier (NTB) in the US.<sup>49</sup> The WTO estimates that 16.7% of all US imports are affected by non-tariff measures. This is a decrease with respect to the pre-Uruguay Round levels, but still the highest among developed countries.

In recent years *antidumping* has been a particularly contentious issue in the international arena. While the US makes extensive use of antidumping measures, more than 80% of these are directed outside of the Western Hemisphere. US antidumping in Latin America has historically targeted steel imports. At present, US antidumping duties are in effect on imports from every major Latin American country, including Argentina (honey, steel), Brazil (orange juice, steel), Mexico (brooms, cattle, cement, various manufactured products, steel). Some of these measures have been in effect for over twenty years. In order to mobilize negotiations for free trade, these barriers must be discussed.

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<sup>47</sup> Scandizzo, Stefania

<sup>48</sup> Scandizzo, Stefania

<sup>49</sup> Republica Argentina – Comision Nacional de Comercio Exterior, “Informe de las barreras a las exportaciones argentines en el NAFTA”

**Preferential Treatment**

The US grants trade preference to members of the Andean Pact (excluding Venezuela), the Caribbean, Chile, and Mexico. With tariffs being phased out with these agreements, an increasing amount of Latin American exports are entering the US duty-free. However, preferences tend to be granted on products that already exhibit low tariffs, not on tariff peak products, therefore many Latin American countries are not benefiting as much from exports and US consumers are not benefiting from lower prices as much as they should.

*Preferential Access to US market*

Type of Agreement	Terms	Countries affected
Free Trade Agreements	Duty free access of all goods to US market	Mexico, Chile, Central American countries
Preferential Agreements	Duty free access for most goods	Bolivia, Colombia, Ecuador, and Peru
Generalized System of Preferentes	Duty free access for most goods, but many exceptions	Mercosur, Venezuela

**Trade Policies of Latin American countries**

Latin American nations made considerable progress in implementing far-reaching trade reforms and opening their economies to outside competition during the first half of the 1990s. The prospects of hemispheric economic integration have spurred new sub-regional integration schemes and breathed life into sub-regional groups that had lost their stamina.<sup>50</sup> Most importantly, the political commitment at the Miami Summit to create FTAA by the year 2005 was a product largely of pressures from many countries in the region.

Since 1990, four sub-regional groups have made considerable progress breaking down intra-regional trade barriers. Mercosur, the Common Market of the South, consists of Argentina, Brazil, Paraguay, and Uruguay and is the second largest preferential trading group in the Western Hemisphere. The Andean Community, consisting of Bolivia (also an associate member of Mercosur), Colombia, Ecuador, and Venezuela (Peru dropped out in 1997), is currently the third largest preferential trading group in the area. Acting unilaterally as well as under the auspices of the Community (formerly the Andean Pact), individual members have liberalized their own trade and investment regimes in recent years. The Caribbean Community and Common Market (CARICOM), consisting of 13 English-speaking Caribbean nations, has agreed to implement a common external tariff over a period of six years, although members will be allowed to maintain their own non-tariff barriers. The Central American Common Market (CACM), originally established in 1961, gained stimulus after a 1990 summit of Central American presidents. Within CACM, the Central American Group of Four – El Salvador, Guatemala, Honduras, and

<sup>50</sup> CRS Issue Brief for Congress – “Trade and the Americas”

Nicaragua – has taken measures to liberalize and harmonize their trade regimes, recently concluding a free trade agreement with the United States.

Most Latin American leaders have generally supported the establishment of a hemispheric free trade area, believing that an FTAA will help bring about greater prosperity, competition, and entrepreneurial activity. A number of critics, however, caution that the United States will benefit the most from the arrangement by demanding further opening of Latin American markets to US goods while following a protectionist course for politically sensitive US industries such as steel and agriculture.<sup>51</sup>

Similarly, many Latin Americans understand that negotiating a free trade agreement with the United States opens themselves to increased competition and potential US involvement in such issues as environmental standards, workers' rights, and intellectual property rights protection. Some worry that as tariffs fall, the United States would increasingly resort to other procedural ways (such as the imposition of anti-dumping or countervailing duties) to protect its producers and workers. Consequently, some nations might not be willing to move as quickly as others toward the goal of free trade. And others, such as Brazil, may attach greater importance and priority to the consolidation and strengthening of sub-regional trade groups before moving towards a hemispheric free trade area.<sup>52</sup>

Beyond that, opposition to hemispheric free trade could grow if the region's unemployment and staggering poverty do not begin to decline. Ironically, freer trade can be the stimulus to create employment and lift people out of poverty. Despite the overall improvement in economic growth during the 1990s, the number of people living in poverty (defined as less than \$ 1 a day) has only dropped from 41% in 1990 to 35% by the end of the decade and picked up slightly since 2001, due in large part to the economic crises in Argentina and Venezuela. As a result, too many Latin Americans have seen little evidence that the shift toward freer trade and more open markets has improved their living standards. This can be largely attributed to incomplete reforms, both on the part of the US and Latin American governments. It is within this context of disillusionment that politicians using populism of demagogic rhetoric have risen to power in Argentina, Brazil, Venezuela, Peru, and elsewhere, vilifying the free market as the source of their countries' troubles.

As a number of countries in Latin America have experienced economic and political turmoil over the past three years, of which the most spectacular was the collapse of the Argentine economy in early 2002, the environment conducive to free trade negotiations has also deteriorated. Economic growth in the region was less than 1% in 2001, barely positive in 2002, and 1.7% in 2003. Continuing crises in Argentina and Venezuela pose special challenges.

### **Major Negotiation Issues**

The FTAA involves a commitment by 34 countries to consider a broad trade policy agenda, the difficulty of which has become increasingly clear of late. Essentially, the United States has many different priorities than some key Latin American countries, making a balanced and mutually acceptable agreement difficult to define, as seen in a short review of the negotiating issues.

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<sup>51</sup> CRS Issue Brief for Congress – “Trade and the Americas”

<sup>52</sup> CRS Issue Brief for Congress – “Trade and the Americas”

*Market Access and Trade Remedy Issues.* These represent some of the most difficult negotiating challenges, particularly given that the two largest regional economies, Brazil and the United States, have different priorities. The United States has an average tariff of 4%, the lowest in the Western hemisphere. But Brazil and other countries argue that many of their exports are subject to US tariff rate quotas (TRQs) and their related high peak tariffs, as well as countervailing and anti-dumping actions. In other words, the United States has tariff peaks on the goods that Brazil and other Latin American countries could potentially export, and low tariffs on goods those countries do not export. Brazil, by contrast, has much lower peak tariff rates but has the second highest average regional tariff of 15% and relies on other trade barriers as well. The United States has focused its negotiation position on reducing overall tariff rates as the primary goal in market access discussions, but its specific offer has differed significantly from what Brazil proposes.<sup>53</sup>

Latin American countries, by contrast, have been pressing to address US trade remedy laws, domestic support for farmers, and peak tariff rates, with Brazil specifically focused on opening the US market further to its agricultural, steel, and textile exports. Agriculture is the most protected sector for most economies – developed as well as developing – and for many Latin American countries, the liberalization of this sector is critical for their economic well-being and expansion. The United States has made it clear, however, that it is uninterested in negotiating an agricultural subsidies agreement that does not include Europe and Japan, which will require resuscitating WTO talks following their September 2003 collapse in Cancun, Mexico, a collapse largely attributed to frustrations over agricultural issues.<sup>54</sup>

*Other Trade Barrier Issues.* Trade in services is another vital issue for the United States given its competitive strength in such areas as financial services, transportation, engineering, and technology consulting. Beyond market access, there are issues critical to the United States that will take center stage, among which intellectual property rights (IPR), government procurement, and competition policy. Intellectual property rights violations have hurt US producers throughout the world and few countries have laws protecting intellectual property rights to the extent the United States does. Copyright issues and protection of digital products are among the more important issues to resolve. Although certain Latin American countries appear uninterested in imposing IPR, they are using this position as leverage against the United States. It is clear that intellectual property rights and patent control are essential for the development of new products, and as developing countries expand into research services, they will too benefit from these laws. Competition policy is another difficult area because of the need to standardize approaches regulating domestic economic activity.<sup>55</sup>

*Labor and Environment Provisions.* Another contentious issue is the language covering labor and environment provisions. Latin American countries resist these provisions, arguing that they: 1) should be left to domestic governing authorities or the

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<sup>53</sup> CRS Report for Congress – “A Free Trade Area of the Americas: Status of Negotiations and Major Policy Issues”

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relevant international organization; 2) may be difficult for developing countries to meet; and, 3) can be used for protectionist purposes. Concern from the United States, on the other hand, is that different standards among trading countries may provide competitive advantages or disadvantages. Specifically, the concern goes to ensuring that lower environmental or labor standards in Latin American countries not become a basis for exploitive, lower-cost exporting, or serve to attract foreign capital investment, and that higher standards, such as in the United States, not be disguised as barriers to trade.<sup>56</sup>

### **The Main Obstacle: The Reciprocity Trap**

The difficulty of negotiating a far-reaching agreement among 34 parties with disparate interests and levels of development is secondary to the obstacle posed by the reciprocity trap. This consists of the systemic failure of successive United States and Latin governments caused by the fallacious belief that it is to their advantage to put off unilateral trade liberalization in order to hold back for trade negotiations.<sup>57</sup> If one country follows this, all other countries are forced to do so as well so as to have negotiating leverage in multilateral negotiations. This fallacy has plagued the Western Hemisphere for almost 10 years, and has stopped liberalizing efforts that were being followed in the mid 1990s. The US has consistently been putting off agriculture liberalization until the EU and Japan do the same, while Latin American countries have been holding off on services market access and IPR until the US reduces its barriers to trade in agricultural products.

Those policies ignore the most basic fact of trade: The benefits of open markets for a country's citizens come from imports, not exports. Lower-priced imports are the source of improved standards of living, which are surely the object of trade.

Thus, paradoxically, the very launching of the FTAA initiative inadvertently helped set up the reciprocity trap. Up until 1994, trade liberalization had proceeded apace throughout the hemisphere through largely *unilateral* openings. With the announcement of FTAA, unilateral tariff reductions screeched to a halt.

In order to break this logjam, the most realistic course of action is for the United States to unilaterally open its market to Latin American agricultural exports by lowering tariffs and doing away with other trade-distorting practices without waiting for the EU and Japan to take similar steps. In addition to providing an immediate benefit to US consumers and taxpayers, this step should give the United States the required leverage (under threat of withdrawing the above benefits) to negotiate comprehensive market access to Latin American markets.

### **Other Obstacles: Lobbies**

The welfare benefits of trade are well-researched and documented. However, these benefits inure to society as a whole and there will always be individual losers. Those hurt – at least temporarily - from a policy of freer trade will be the investors and workers in hitherto protected sectors of the economy. When powerful enough, those affected will tend to organize in lobbies that will work toward either blocking the liberalizing legislation or obtaining compensatory measures from government.

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<sup>56</sup> CRS Report for Congress – “A Free Trade Area of the Americas: Status of Negotiations and Major Policy Issues”

<sup>57</sup> O’Grady, Mary, “First, Open Markets”

The lobbies affecting interests affected by trade legislation are often powerful, both in the United States and in Latin America. The power different lobby groups have over their respective governments is vital to understanding the ability or inability of a local government to enact legislation that favors the population as a whole while ignoring special-interest groups.

*United States Lobbies.* Market access for Latin America's agricultural products is the most significant source of disagreement toward the formation of a free trade area. The agricultural sector influences government decisions concerning agricultural trade throughout the developed world, and the United States is no exception. In the wake of the enactment of the Farm Bill, the Cato institute called the United States' farm policy "an equal opportunity disaster", whose victims include tens of millions of American families who must pay higher taxes and higher grocery bills (which disproportionately hurts low-income families), hundreds of millions of farmers in the developing world, and ultimately American farmers themselves.<sup>58</sup>

The most active citizen participants in the development of the Farm Bill have not been representatives of taxpayers and consumers, but the leaders of several large farm organizations. Not coincidentally, most analysts agree that the farm lobby is the largest beneficiary of legislation that increased farm subsidies to \$ 191 billion over the next 10 years.<sup>59</sup>

Current U.S. agriculture subsidies to farmers increase with crop production, guaranteeing that the largest and most profitable farms receive the largest federal subsidies. In addition to subsidies, assistance is given to farmers in the form of price supports, through which crop prices are artificially increased, encouraging overproduction that depresses prices outside the US. The lion's share of this assistance, likewise, goes not to farmers who are most in need, but to large farms that grow the most crops. Two-thirds of all farm subsidies go to just 10 percent of farms, most of which earn over \$ 250,000 annually.<sup>60</sup>

Because the largest agribusinesses are the chief beneficiaries of agriculture policy, they have both the incentives and resources necessary to invest heavily in maintaining the current flow of subsidy dollars. Through representative organizations they have served on federal commissions, testified before Congress, and donated millions of dollars to federal political candidates. Not surprisingly, the current Farm Bill includes many of the provisions that these groups support, including massive farm subsidies and protectionism. The chief beneficiaries of the current Farm Bill are the producers of subsidized commodities, sugar growers, peanut producers, and dairy farmers.

*Producers of Subsidized Commodities.* Organizations representing the farmers of the subsidized crops (wheat, corn, cotton, soybeans, and rice) are responsible for much of the \$ 69.6 million that agribusinesses have donated to congressional and presidential candidates since 1999. Several of these organizations were also represented in the 11-member Commission on 21<sup>st</sup> Century Production Agriculture. Pro-farm subsidy organizations such as the Washington Office of the American Farm Bureau Federation, which made large

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<sup>58</sup> Griswold, Daniel T. – "U.S. Farm Policy: An Equal Opportunity Disaster"

<sup>59</sup> Riedl, Brian M. – "Agriculture Lobby Wins Big in New farm Bill"

<sup>60</sup> Riedl, Brian M. – "Agriculture Lobby Wins Big in New farm Bill"

investments to promote expanded farm subsidies will be able to claim credit for increased government payments to their membership.

*Sugar Growers.* Currently, the federal government provides benefits to sugar growers through price-setting policies that artificially raise the prices that consumers pay for sugar, rather than through direct subsidies. These price-setting policies contain the following elements: (1) strict tariffs and import limits to prevent competition from cheaper imported sugar; (2) non-recourse loans to sugar processors, which revert to the status of grants if the price of sugar drops below a certain level; and (3) domestic limits on how much sugar can be processed.

All told the sugar program increases the price of sugar to three times the world market price, an increase that is multiplied throughout the food market, since sugar is an important ingredient throughout it.

The largest beneficiary of continued government price-fixing in the sugar industry is Florida's Flo-Sun, Inc. which actually receives a \$ 65 million sugar benefit from the federal government for its Florida-grown sugar and an additional \$ 60 million for its sale of Dominican sugar in the United States. The Fanjul family, which controls Flo-Sun has donated \$ 1,136,900 to federal politicians since 1999.

*Peanut Producers.* While the sugar industry has been actively lobbying to maintain its price supports, the peanut industry has dedicated its resources to promoting a shift from price supports to taxpayer subsidies for peanut production. Currently, peanut prices are increased to artificially high levels through import restrictions and non-recourse loans. Prices are also kept high through domestic shortages that have been created by limiting permission to grow peanuts for domestic sale to those who possess marketing quotas – licenses to grow a specific amount of peanuts. These government-created shortages raise the price of peanuts sold in the United States to double the world price.

For years, Congress has talked about eliminating peanut price supports, and the peanut industry has worked actively to ensure that any such change will preserve government benefits to the peanut industry. In testimony before the House Agriculture Committee on June 18, 2001, Western Peanut Growers Association (WPGA) President Doyle D. Fincher proposed replacing the existing peanut price support system with direct government subsidies to peanut growers and called for massive government payments to compensate holders of peanut quotas for the loss of the value of their quotas. The wishes of the WPGA were granted when legislation was enacted passing the cost of peanut subsidies from consumers to taxpayers.

*Dairy Farmers.* The dairy industry is also a main benefactor of the Farm Bill. Current law is based on the perception that Midwest dairy farmers produce milk too efficiently, resulting in milk prices that are too low. In response to this situation, the federal government allows states with less efficient dairy farmers to establish local milk cartels to keep less expensive Midwest milk off the market and sustain artificially high prices for milk produced in those states.

Much of the \$ 3.3 million donated to federal candidates by the dairy industry since 1999 has been from dairy farmers who support continuing the current price-fixing scheme.

However, the importance of campaign contributions as a means for lobbying should be put in perspective. In a recent paper aimed at understanding the influence of the steel lobby on American trade policy<sup>61</sup>, Jose Anson analyzes the roll-call vote of the steel import quotas bill H.R. to measure to which extent campaign contributions by the steel lobby and its counter lobby, represented by the automobile sector, influence the likelihood of approving the bill. Anson concludes that money has had a very limited influence on U.S. steel trade politics<sup>62</sup>. Without a doubt, traditional values on self-sufficiency and pride in the “Made in USA” logo have considerable weight in deciding on trade legislation. Regardless of this, the inter-connectedness, cooperation and efficiency and cost gains that result from trade between countries pulls enough weight to transform an informed public into advocates of free trade.

### **Latin American Lobbies.**

Lobbying activities in Latin America are far more opaque than in the United States – and are at times based on corrupt conduct. Precisely because of that lack of transparency no systematic studies have been conducted in Latin America concerning the power of lobbies. Therefore, most of the evidence of lobbying activity in Latin America we possess is circumstantial and, in many cases, comes from hearsay. Suffice to say that every substantial sector in the economy potentially threatened by freer access of US goods (e.g. the auto industry and its workers) is active in attempting to block or water down the FTAA initiative. A recent example of the power of lobbies representing protected industries in Latin America was the Argentine devaluation of early 2002, after over a decade of foreign exchange stability. This radical policy change, which resulted in over 50% the population of that relatively rich country falling below the poverty line is believed to have been actively promoted by the industrial lobby (Union Industrial Argentina) with the goals of having its constituents’ debts diluted and their markets protected.

Obstacles to free trade and opposition groups will always arise, but the ultimate goal of creating a free trade area should not be lost. Trade liberalization will offer economic gains to citizens of all countries involved, as well as providing positive externalities in the form of cultural awareness and political partners that diminish security threats. If these positive aspects were diffused throughout the population (perhaps through a marketing campaign), the support of the masses will be able to drown out the pleas of self-seeking special-interest groups that are the ultimate obstacle to trade liberalization.

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<sup>61</sup> Anson, Jose – “Steel Trade Policy Lobbying at U.S. Congress: How Much Does Money Matter?”

<sup>62</sup> Anson reaches his thesis by quantifying the expected marginal cost to getting a majority of the House vote at \$ 28,917, a value which is likely to be insignificant with respect to the marginal benefit of the tariff-equivalent quota.

## **Convergence in the Western Hemisphere: FTAA vs. Pan-American Union**

With negotiations for the FTAA (Free Trade of the Americas) behind schedule, the opportunity presents itself to re-consider the current approach to increasing trade ties with Latin America. A new – more ambitious - approach may leapfrog the envisaged free-trade zone and premise institutional convergence as its ultimate objective. The current model for integration is that of an expanded NAFTA- all member countries would constitute a free trade area with no significant institutional convergence. The assumption behind this model is that free trade alone will provide incentives and capital for economic growth within all member countries. However, an approach premised on institutional convergence and cooperation, along with the creation of supranational authorities, such as those functioning in the EU, would facilitate the desired increase in regional trade.. Moreover, the current approach to integration, based almost exclusively on economic factors ignores political and social issues that are vital for sustainable development and growth. While economic incentives encourage political transparency and efficiency, they can create an area of competing politics that ignore social issues, such as the environment and equality. Alternatively, prospective members of an institutional union would be required to relinquish aspects of their respective sovereignty. Despite this loss, the establishment of supranational institutions provides legitimacy in protecting and promoting the common good.

In spite of recent troubles, the United States has had positive experiences dealing with supranational organizations. More often than not, the U.S. has been successful in aligning these institutions' agendas with its core objectives of promoting peace, the rule of law, and the promotion of better standards of living throughout the world. Supranational institutions can or cannot be weighted given the size or economic power of a member country. Given its disproportionate economic and political might, any regional policy-making body will naturally have to give the United States an appropriately weighted participation. Proper supranational authorities would facilitate the implementation of the longstanding US agenda for the Americas, involving the strengthening of democratic politics and market economics, the promotion of free trade, and the cooperation on security threats including terrorism, drug trafficking and threats to constitutional rule. Regional cooperation in these areas and the creation of common policies can provide credible joint action to alleviate these threats.

The European Union (EU) epitomizes the success of supranational institutions in the integration process and for sustainable development thereafter. During the 1980s and 90s it helped the “Poor Four” countries (Ireland, Spain, Portugal, and Greece) converge to EU income levels while maintaining high social and environmental standards. It is now trying to repeat this process with the 10 new, and much poorer, members accepted to the union in May 2004. While NAFTA already has some supranational institutions that enact rules for all its members, the FTAA must go beyond this to hurry the integration process so that its benefits can be maximized. Attaining a level of integration comparable to that of the current EU may take some time, but this option should be considered along the way. A politically and economically integrated Western Hemisphere (“Pan-American Union”, or “PAU”) would not only provide stability for developing countries, but it will also provide numerous efficiency gains. A crowning

achievement of such a union could be the creation of a single regional currency (an altered version of the dollar or a new currency), which will give substantial weight against the increasing might of the Euro. Clearly, considering an alternative and more ambitious approach involving the developments of strong incentives for all prospective members and much greater potential rewards can stop the current lull in FTAA negotiations.

### **Supranational Institutions and US Involvement**

Although the debate concerning the trade-off between national sovereignty and supranational institutions continues, it is undeniable that the world has been relinquishing aspects of national sovereignty to embrace supranational authority. In joining supranational institutions, member states maintain their overall sovereignty while surrendering some aspects to the common institution. These institutions facilitate the process of integration and decision-making by providing transparency, support, strength, and predictability. Increasingly, national sovereignty is becoming passé; unilateralism is frowned upon and can lead to isolation by the world community. For members of the EU, the era of absolute national sovereignty has been over for some time.<sup>63</sup> Like the EU, for the Americas a convergence approach will require the creation of supranational institutions that would be responsible for creating common policies and adjudicating disputes.

In Latin America, sub-regional institutional integration has been commonplace since the 1960s. However, these efforts have largely failed because they have been inter-governmental, meaning regulated by heads-of-state, and not supranational. Because of this, they lacked communication and a consistent agenda. Though attempting to integrate the region, changes in government and ideology propelled delays in further institutional and economic convergence. Moreover, in times of social and economic troubles national politics ignored the long-term agenda. This is why the integration of the Western Hemisphere will require the creation of supranational institutions and needs the leadership of the United States. These institutions will not lose track of the agenda of additional convergence efforts, paving the way for smooth integration.

The United States has selectively embraced supranational institutions, recognizing their evident advantage in trans-border cooperation. For example, beyond its participation in multi-lateral organizations such as the United Nations and the World Trade Organization, the United States is yielding sovereignty to NAFTA institutions. Despite its obvious shortcomings, for over 50 years the UN has been an instrument of peace and maintaining the rule of law to promote better standards of living, principles shared by the United States. Albeit imperfectly, the United Nations has helped further democracy, economic liberalization, decentralization, accountability, the rule of law, and freedom of speech.<sup>64</sup> In particular, the Security Council is a supranational authority that lends international credibility to actions taken by countries. Although its voting structure limits its members' sovereignty, the US has recently been able to prove that when national security is at stake, it can maneuver around it.

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<sup>63</sup> Alberts, Tanja. "The Future of Sovereignty in Multilevel Governance." Journal of Common Market Studies. Oxford: March 2004.

<sup>64</sup> "The Best World Club We Have." *The Economist*. Nov. 22, 1997.

Nowhere is the highly theoretical loss of U.S. sovereignty in the prospective Pan-American Union more evident than in comparison with the Bretton Woods institutions (International Monetary Fund and World Bank). These institutions' goals of promoting international financial stability and eradication of poverty are heavily aligned to US policy. Although the supranational nature of these institutions gives appointed officials the ability to dictate policy (through conditionality) that can or cannot be in the interest of the United States, voting power is weighted based on each member's contributions to the organization. With a 17% weight on its vote, the United States has sufficient power to veto constitutional reforms to the above institutions, which require the vote of 85% of contributions. Despite the fact that the Bretton Woods institutions are in a position to approve aid packages including United States funds without the support of the U.S representative, neither the IMF nor the World Bank have ever proven to be a threat to the US agenda. On the contrary, the use of these international organizations has helped provide credibility and support to further that agenda.

The WTO is another example in which the US has surrendered a degree of pure sovereignty while gaining international support. The empowerment of this supranational body facilitates the capture of gains from commerce, boosting the utilities of all participants. In exchange, the WTO makes sure the United States and other members do not retreat from the free trade policies embedded into its doctrine. Moreover, instead of countries engaging in tit-for-tat retaliation on trade policies, they bring trade disputes to the WTO, encouraging international cooperation. As the saying goes, 'Where there is trade there is peace'.

Clearly, the United States has participated in supranational institutions in which the economic and other benefits outweigh potential political losses. Moreover, due to the economic weight of the US, participation in these institutions has not significantly threatened sovereignty. Whenever the US agenda has been aligned with that of the supranational authority, cooperation increased credibility and quickly settled the problem. A supranational authority in the Americas will align policy in the Western Hemisphere and create a bloc of countries with a collective interest in the success of the region that can easily react to situations and take actions to resolve them.

Already, the North American Free Trade Agreement demonstrates advancement in supranational participation by the United States. With concessions given up by Mexico, Canada and the United States, the agreement entails a loss of sovereignty for all participating members for the common good. The Free Trade Commission, which formulates creating customs and transportation regulations, is an example of impositions accepted by the United States by a commission headquartered in Mexico City. Also, a formal dispute resolution system, similar to the one in the WTO, mitigates the possibility of defection while encouraging cooperation. These regulations have helped increase trade faster than output. Also, the prospect for swift adjudication of disputes encourages the use of this system instead of engaging in retribution. Although not analogous, the Free Trade Commission and system for settlement of intra-regional trade disputes shares the goals of the European Council of Ministers and the European Court of Justice, the EU's fundamental governing institutions. While not having yet explicitly embraced the concept of regional convergence, the United States is already on its way. The Western Hemisphere is in a position to look at the EU as a roadmap for economic and institutional integration. With these guidelines, it can follow a path to convergence that will promote

cooperation and lead to increased growth, trade and, most importantly, security in the region. In the next section, the success of European integration will be discussed, keeping in mind possibilities for an American Union, encompassing the democracies of the Western Hemisphere.

### **EU Success in Institutional and Economic Convergence**

Instead of NAFTA and the FTAA following a narrow approach to integration consisting of economic incentives, the Western Hemisphere should look at the European Union as an example of an advanced regional integration project. Currently, the FTAA is working under the premise that economic incentives encourage for political transparency and efficiency. While this is true, institutional convergence can work as a catalyst to accelerate and deepen these reforms. The EU provides a successful framework that not only increased trade and political cooperation, but also brought up poor countries to become global players.

By combining economic incentives with social and political harmony, the EU has been able to reduce disparities between and within nations and establish legally binding social and environmental protections. Although giving up slices of national sovereignty, member countries have instead opted for a shared destiny and cooperation on social and economic progress. The importance of diminishing income disparities between countries rests on its effect on the reduction of insecurity, increased economic activity, and a decrease in migration pressures across borders. Because these are important aspects of the US agenda in Latin America, the EU framework provides a good model that the Americas can follow.

In the 1970s and 80s the EU expanded to include the “Poor Four”. The inclusion of Ireland, Greece, Spain, and Portugal into the rich European Union created worries of mass migrations of peoples to richer countries and of companies fleeing to areas of cheaper labor. Some of the original members doubted the wisdom of the inclusion of these countries because they had so little to offer in terms of exports and importing purchasing power. This parallels the rationale for US inhibitions in joining a union with its poorer southern neighbors. However, as we can learn from the European experience, with the proper planning of supranational and inter-governmental institutions, agendas can be created to eliminate disparities between countries, increasing their capability to trade and eradicate threats that inequality create, such as mass migration and security threats.

The EU experience for the inclusion of poor countries has revolved around economic assistance to these countries in the form of Development Funds. These Development Funds have been central to the inclusion of the Poor Four and are on the agenda to facilitate the transition of the 10 new member (and much poorer) nations to full members of the EU. Ostensibly, the Development Funds are a commitment by the union to reduce income disparities. The European Union firmly believes that strengthening the union between countries and ensuring harmonious development is best achieved by

reducing differences between regions.<sup>65</sup> This will expand a region's capacity to consume, thus increasing trade and regional cooperation.

On the other hand, the proposed FTAA assumes that the reduction of trade and investment barriers alone is enough to lift the standard of living in less-developed countries. Currently, there is no mechanism devised to reduce disparities through aid, but inequality is becoming a more important factor in negotiations. Aid to reduce disparities and raise the income of Latin American countries would accelerate growth in Latin America and in the United States. The US will benefit from Latin American growth through increases in exports and stability in the region. In 2002, the Hemispheric Cooperation Program (HCP) was developed to increase the trade capacities of countries by providing technical assistance to train government officials in FTAA negotiations. The US government allocated \$102m to the HCP.<sup>66</sup> However, since this is not written into FTAA negotiations, there is no binding commitment for its support. Therefore, the region cannot benefit from the stability that steady aid could provide.

Moreover, the sum of \$102m in aid falls well short of EU investment into its poorer members. Between 1961 and 2001 the EU funneled €325 billion into development grants, a sum ten times greater than US economic aid to all Latin American countries during the same time period. The investment had great results. Most of the aid to Ireland, Greece, Spain and Portugal began after 1988. The money is put into Structural Funds, which are divided as follows:

1. European Regional Development Fund
  - a. Promotes economic and social cohesion, primarily by co-financing productive investment leading to job creation; infrastructure; and activities of small- and medium- enterprises
2. European Social Fund
  - a. Aims to prevent unemployment through education and promoting opportunities for women, youth, and long-term unemployed
3. Cohesion Fund
  - a. Finances projects designed to improve the environment and develop transport infrastructure in member states where per capita GNP is below 90% of EU average<sup>67</sup>

The Structural Funds are grants, not loans, that national government help to co-fund. These cannot be used as income support, but instead are designed to support economic growth with investment in infrastructure and training. The success of these is unquestionable.

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<sup>65</sup> Anderson, Sarah and John Cavanagh. "Lessons of European Integration for the Americas." Institute for Policy Studies. Washington, DC: Feb. 2004.

<sup>66</sup> Anderson, Sarah and John Cavanagh. Lessons of European Integration for the Americas.

<sup>67</sup> Although 9% of the total also goes to the support of rural development and structural reform of the agriculture sector, it is predicted that these will subside as WTO negotiations continue.

Since the Structural Funds became more heavily funded in the 1980s, Ireland, Spain and Portugal have enjoyed an unprecedented level of income convergence with fellow EU members. Ireland's GDP per capita, which in 1982 was a mere 65% of the EU average, has skyrocketed to 131% of the average, and the country is now a net lender rather than a receiver of aid. Spain and Portugal, whose GDP per capita were 75% and 62% of the EU average in 1982, had converged to 82% and 71%, respectively, by 2002. The funds are also expected to have added 10% to the GDP of the Poor Four between 1989 and 1999, simultaneously creating 2.2 million jobs. Beyond economic prosperity, the funds have improved governance, thus making the countries more attractive for foreign investments.

Ireland, the most successful of the beneficiaries, is important to set apart because it had had liberal trade practices since the 1970s. However, it did not grow quickly until it started receiving a significant amount of development aid after 1988. It now boasts the strongest technology sector in Europe, and unemployment has decreased from a high of 17% to 4%. It has even managed to reverse emigration trends, with thousands of second generation Irish returning home. Moreover, Ireland has become the 6<sup>th</sup> largest contributor to developing country aid, contributing 0.41% of its GDP. This success is mostly contributed to the Cohesion Funds, which developed the transport infrastructure Ireland had lacked for so long. With proper organization, this same success story can be repeated in Latin America.

For many, the large bill attached to the development funds seems too high. However, advancing the economic position of neighboring countries is not without its advantages. Richer neighbors would prove to be less of a potential security threat to the United States and would simultaneously become more attractive markets for US goods. As Vasco Cal, a member of the EC's Regional Policy Department said, "What's the point of having an agreement with countries without one buck in their pockets?"

### **Institutional Convergence: Foreign Policy and Security Threats**

Beyond common economic policy, the European Union also created a common foreign policy in order to react more effectively in times of security crisis. Over the past 50 years the ex-rivals have become committed to peacefully dealing with disputes and cooperating through common institutions. In today's world of bright prospects but greater threats, no country can act alone.

Terrorists and criminals today act on a world stage; terrorists in one area pose a direct threat to civilians in another. The EU has opted to mitigate this threat by increasing global communication with the weight of its 'Common Foreign and Security Policy' (CFSP). By encompassing more countries into the union, borders with potential threats expand. However, common legislation demands stringent control. As a result of this imposition of strategic and credible policy by common institutions, there is pressure to reform troubled areas while encouraging political and economic cooperation. A common security policy in the Americas would significantly add to the security of all the countries in the region. The practicalities of such common policy would encompass banking regulations, immigration controls, arms displacements, and import-export management.

The extent of European cooperation has reached the point where it now publishes a joint security strategy. Enforcing the position of the EU and all its members, it provides legitimacy in action taken against terror and encourages the involvement of other nations:

“In a world of global threats, global markets and global media, our security and prosperity increasingly depend on an effective multilateral system. The Development of a stronger international society, well-functioning international institutions, and a rule-based international order is our objective.”<sup>68</sup>

This policy is the consequence of the convergence approach taken by the EU and enables its members to take recognizable action against threats. A similar approach in a prospective Pan-American Union would have a similarly empowering effect.

Militant Islamic fundamentalist poses the greatest threat to the security of the United States. It is suspected that there are numerous Al-Qaeda and other terrorist links in Latin America.<sup>69</sup> The US cannot unilaterally eliminate that presence, and individual countries do not have the means of preventing threatening actions. Moreover, because of inconsistent information between countries, it is easy for terrorists to hide below the bureaucracy. Terrorist activity will be easier to trace and subdue once a Pan-American Union legislating common rules and regulations is in place. As the threat of global terrorism increases, and with al-Qaeda recruiting possible members and laundering money in Latin America, the need for institutional convergence and cooperation has never been greater.

In order for institutional convergence to succeed, supranational institutions must be created along with some inter-governmental ones. The EU currently possesses the following leading institutions, of which the first two are intergovernmental:

1. European Council
2. Council of Ministers
3. European Commission
4. European Parliament
5. European Court of Justice
6. European Court of Auditors

While some of these are in different levels of development, the European outline for gradually conceding power to the supranational institutions encourages cooperation in economic and political initiatives.

Similar to the European Council and the Council of Ministers, countries set to participate in the FTAA should encourage regional talks between leaders by setting dates for hemispheric meetings to occur once or twice a year. Facilitating talks, decision-making, and encouraging common policy, the commitment to yearly meetings is a vital step in providing consistency and cooperation. Simultaneously, a commission of independents committed to working towards the common interests of the region should operate to suggest legislation. Working cooperatively with the Councils that represent government interests, the two institutions are staged to converge as time progresses.

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<sup>68</sup> “A Secure Europe in a Better World: European Security Strategy.” Brussels, 12 December 2003

<sup>69</sup> Rodriguez, Olga R. “al-Qaida Said to Recruit in Latin America.” Aug. 22, 2004.

Those institutions are the most important in setting the stage for regional cooperation and creating a policy of inclusion within the Americas. As countries converge economically due to increased free trade and aid distribution, new institutions will emerge to deepen level of interaction. These can include a directly elected Congress, with members from every country, a Court of Justice, and a joint monetary system to facilitate financial, commerce, and other interactions between countries.

### **Dollarization and Monetary Union**

The possibility of establishing a common currency in the Americas has been in discussion for some time, and since the success of the Euro, the option has been becoming more realistic. Two options for establishing a common currency throughout the area are: 1) dollarization, the unilateral acceptance of the dollar throughout the hemisphere and 2) a Monetary Union, which would establish a new currency with a new supranational central bank establishing monetary policy. Undeniably, either process would first involve trade liberalization and the synchronization of business cycles to minimize costs. A common currency would provide lower transaction costs, increased economic and financial efficiency, and increased trade and investment, thus allowing all members to reap even more of the potential benefits of integration.

The dollar presently acts as the means of exchange in Panama (since 1904) and Ecuador (2000), but acts as the currency for corporate accounting and savings for most countries in the Western Hemisphere, including Canada. As exchange rate instability inhibits the long term planning necessary for economic development, the adoption of a common currency emerges as an attractive possibility for many countries. The process of dollarization would imply increased seignorage revenues for the United States and monetary stability for Latin America. While every other country would relinquish its monetary control to the Federal Reserve System, the United States would surrender no sovereignty. Moreover, the broader use of the dollar will further increase its position as the world's reserve currency, a position that is increasingly threatened by the strength of the Euro.

With the dollarization of entire nations, the higher demand for US dollars will increase the seignorage revenues enjoyed by the Federal Reserve, thus boosting revenues in the United States and improving its balance of payments. Because the dollarized countries would no longer print their own money, they would forgo this revenue in exchange for price stability. Although seignorage revenue is said to account for nearly 0.5% of a country's GDP, this is considered insignificant when compared to potential gains for the country. Dollarized countries would surrender revenue, but they would benefit from price stability, and increases in trade, jobs, and investment. As an incentive for prospective members to dollarize the United States could return a portion of the incremental seignorage revenues.<sup>70</sup> In addition to the increased seignorage revenues the United States would benefit from increasing the demand for dollars, the US would also become less vulnerable to the whims of the foreign holders of dollar-denominated reserve assets.

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<sup>70</sup> In 2000, Senator Connie Mack of Florida introduced legislation that would, if certain criteria were met, share seignorage revenue with countries that dollarize.

Sovereignty issues also come into play as countries give up their ability to conduct monetary policy and no longer possess a lender of last resort that can be used in troubled times. With dollarization, the Federal Reserve System becomes the central bank for all countries that use the dollar. However, under a dollarization scheme, the dollarized countries would have no say on monetary policy. Though many have argued this as a positive aspect, since interest politics can no longer get involved in bad economic policy (as is often the case in Latin America), this loss of sovereignty may leave the dollarized countries vulnerable to banking crises and a lack of policy response in case of a sharp divergence between the growth rates of the U.S. and the other members. From the standpoint of the United States, on the other hand, the dollarization of neighboring countries would not infringe on its sovereignty. However, it would be difficult for the Fed to ignore information if the monetary situation becomes distressed in a dollarized country. In this case, not altering monetary policy could create a situation that would lead to tension and discourage coordination, representing a potential threat to an otherwise successful union.

For this reason, creating a monetary union in the Western Hemisphere based on the dollar should be considered only as a first step in the process of convergence of institutions. Once prospective members have dollarized, the United States can hold out a true monetary union as an incentive to be delivered upon the achievement of a record of fiscal and political stability on the part of the dollarized countries. Expanding the existing Federal Reserve System, by establishing new Feds in significant economic areas, such as Canada, Mercosur and Mexico, will give members of the region a lender of last resort and a voice in the setting of monetary policy without the United States losing control over the institution.

Before this becomes a possibility, however, the region must improve on the current situation in order to make dollarization a more attractive and viable possibility. While dollarization increases the trade between countries, trade between countries must be high in order for the transition to dollarization to succeed. Dollarization of an economy, like imposing a fixed exchange rate, is most appropriate for economies closely integrated through international trade and factor mobility.<sup>71</sup> Presently, Canada and Mexico are the best candidates, but with prospects for integrating the rest of the hemisphere's democracies, trade and factor mobility are destined to increase within the region, facilitating and encouraging the dollarization process.

The achievement of a true monetary union would be gradual and premised on the fact that smaller 'monetarily independent' countries have largely deceptive control over their monetary policy. Interest rates set in the United States and Europe affect smaller economies heavily with volatile exchange rate fluctuations or security/bond prices. Dollarization and/or Monetary Union would mitigate this effect. Though dollarized countries on a path to monetary union would no longer be able to adjust exchange rates to smooth external shocks, three other adjustment mechanisms would still be available in case of external shocks. These are adjustment of prices, fiscal stabilization, and

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<sup>71</sup> Gruben, William. "Dollarization and Monetary Unions: Implementation Guidelines." Federal Reserve Bank of Dallas. Dallas, TX: 2001.

Harris, Richard. "The Case for North American Monetary Union." Canadian Institute for Advanced Research.

automatic stabilizers such as unemployment insurance and tax transfer systems. This is what happens in large countries with distinct areas, such as the United States. Nevertheless, US participation in a Monetary Union would be no different than its participation in other supranational organizations. Although it would surrender a very limited amount of pure sovereignty, it is a clear case in which economic benefits outweigh supposed costs of more limited national sovereignty.

### **FTAA vs. Pan-American Union**

Now that FTAA negotiations are stagnant, a more comprehensive framework to regional integration should be considered. Using the European Union as a model, the Pan-American Union would go beyond liberalizing trade in the region. As we have seen, a Pan-American Union would increase coordination between countries, develop a common foreign policy, and maximize coordination between national economic and security agencies by creating supranational and intergovernmental institutions. While potential gains of an FTAA include increased trade, which will increase transparency, maximize efficiency and clean up government, inaugurating an agenda with institutional convergence in mind, all the potential gains of the FTAA are accelerated and amplified. Despite accepting the loss of some national sovereignty, the Pan-American Union will provide a solid and unified foundation for promoting a world agenda of promoting peace and prosperity.

Trade is the foundation on which both the FTAA and the Pan-American Union would be built. The FTAA will encourage the trade of goods and services by eliminating tariff and non-tariff barriers to trade. While this economic incentive will surely bolster the movement of merchandise and encourage investment, creating a Pan-American Union will foster the harmonization of institutions. Also, increased cross-boundary relations will reduce hesitations to invest in previously remote areas. Moreover, threats of contract infringement and other legal violations will be reduced due to the common legislation and dispute settlement authorities established under the Pan-American Union. Because of this, trade will flow more freely, paving the way for faster institutional reform including increased transparency and superior governance.

Although the economic incentives of trade are said to improve governance by setting up more transparent institutions, intergovernmental and supranational authorities can accelerate this process. Governments in different countries can coordinate their modifications better with periodical meetings, and supranational authorities can give recommendations for improvements and even enact a timetable for changes. With free trade as the only incentive under the FTAA, national political issues can postpone changes that would be otherwise beneficial to the country and its neighbors. The proposed Pan-American Union will have politically non-aligned institutions that would ensure the path for common good.

Moreover, while the FTAA will promote regional cooperation as interests begin to converge, the Pan-American Union guarantees political cooperation due to the common agenda developed by the region. As mentioned before, the advantages of regional cooperation are numerous. Not only will a unified front provide legitimacy in actions taken against potential threats, but also it will be stronger in its ability to destroy them. This is true for global threats such as terrorism as well as regional dangers like drug trafficking and arms smuggling. These are real threats that endanger the lives of

citizens everywhere. As we have seen over the past decade, a single country cannot tackle these issues on its own. Regional cooperation in the Western Hemisphere increases the front against these threats, and encourages further global participation to eliminate them.

Merely a free trade area that seeks to promote regional cooperation, the potential gains of the FTAA are belittled when compared to the gains that the Pan-American Union will bring. Presently, FTAA negotiations are sluggish, and the possibility of achieving the January 1, 2005 deadline is obsolete. Leaders must look at alternative solutions and more ambitious plans in order to not lose momentum on this agreement that would benefit the 880 million citizens of the Western Hemisphere. Regional integration should be a top priority for the United States.

