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ECONOMIC INTEGRATION IN LATIN AMERICA

by

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Agency for International Development

THIRTEENTH SESSION

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ECONOMIC INTEGRATION IN LATIN AMERICA

Before describing the various integration efforts in Latin America it would be useful to establish what we mean by economic integration.

Economic integration is the term used to cover a variety of different ways of tying the economies of two or more countries together. The two most common, and the only techniques attempted in Latin America are 1) a free trade area and 2) a common market.

A free trade area is established when several countries agree to lower trade barriers among themselves with the goal of achieving free trade in the area while maintaining their tariffs and trade restrictions against all countries outside the area. This gives the countries in the free trade area an advantage in exporting to the member countries.

A common market not only calls for lowering trade barriers among its members aiming at free trade but also provides for establishing a common external tariff on imports from countries not in the common market. This gives equal incentives and opportunities to people in each of the member countries to produce for the common market as a whole--everyone has equal protection under the law.

The advantages of economic integration have been considered to be so overwhelming that despite the quantity of material on specific aspects of the various integration efforts, there has been surprisingly little written on the pros and cons of integration *per se*. The tendency has been to assert a few general propositions which appear to be self evident, such as 1) a large market is preferable to a small market or 2) increased area trade increases area income or 3) increased trade binds the countries togehter in useful ways or 4) industrialization can be fostered by a larger protected market.

Perhaps it would be useful to look at some of the things that can go wrong also--unless specific steps are taken to prevent their occurance. Economic integration can result in any or all of the following:

1) higher prices
2) poorer quality goods
3) structural unemployment
4) apparently diminished sovereignty
5) gains by the rich at the expense of the poor
6) uneconomic (hothouse) industry
7) important revenue loss (from tariffs)
8) some new investment drawn to other participating countries through artificial incentives for which losing country shares part of the burden
9) less developed countries and areas suffer the most

How is it possible that the consensus is so strongly in favor of economic integration then? In the first place many of the disadvantages listed can be avoided if care is used in the specific form of integration undertaken. Also economic integration does have important advantages such as the following:

1) political gains
2) economic advantages--larger market, etc.
3) industrialization is promoted.
4) the member's bargaining position <u>vis a vis</u> larger countries is improved
5) competition within the subgroup may be better than none at all
6) wiser economic policies may be more acceptable if in the "common interest" when vested interests are difficult to overcome in a single country.

Rather than attempting to discuss the pros and cons in the abstract, however, a look at the specific examples in Latin American would seem to be more productive.

<u>The Latin American Free Trade Area</u> (<u>LAFTA</u>)

Eleven countries (including the big three--Brazil, Mexico and Argentina)are members of LAFTA. Originally LAFTA was proposed by technicians as a means of providing a form of protection which was permissable under GATT regulations. The theoreticians jumped quickly on the bandwagon. The politicans saw political advantages and supported the idea. At first LAFTA made rapid progress but then some of the problems which have plagued LAFTA ever since began to surface. LAFTA is just too large and diverse to achieve the solid political consensus or have the common interest essential to real progress. The large countries proved to be unwilling to give up anything significant to the smaller countries. Everyone wanted to export and no one wanted to import. Despite repeated efforts to breathe new life into LAFTA, the current status is something less than the dynamic vigorous organization and cooperative effort originally anticipated. LAFTA's current situation seems to reflect the desires of the big three countries. The main current activity is the negotiation of complementation agreements among the big three themselves. These do permit increased trade among the big three in the products covered by the agreements and also permit companies to rationalize production in these products among the big three. Progress toward further tariff reductions for LAFTA as a whole are stalled, however. A series of studies is underway taking another look at the basic questions. These studies are to be the basis for further discussions in 1974. Until then nothing much is likely to happen except for a few additional complementation agreements among the big three.

If LAFTA's accomplishments are measured against the more optimistic hopes of its more enthusiastic proponents it is far from an outstanding success. If, on the other hand, it is measured against what could have realistically been accomplished, particularly when political support from the big three countries was lukewarm at best and the diversity of the eleven countries is taken into account, LAFTA appears to have been useful. It did fulfill the task assigned to it by the technicians who proposed it, i.e. it did permit a degree of protection for industry in Latin America which would have been difficult to maintain under GATT regulations otherwise. This alone in the opinion of several observers I talked with has made LAFTA worthwhile. Also LAFTA has provided a forum for discussions on trade and economic policies among the members. A number of technical studies have been developed which have added to knowledge of integration techniques. Finally, the Andean Group has drawn heavily on the LAFTA experience in an attempt to avoid repeating some of the mistakes and weaknesses of LAFTA.

The Central American Common Market (CACM)

Until the "soccer war" in 1969, the five countries in the central American Common Market were making what appeared to be exemplary progress. Trade within the common market had mushroomed. Development of industry was proceeding; several cooperative mechanisms and organizations were in operation. However, if there has ever been any doubt of the primacy of politics, the "soccer war" should dispel them. The economic advantages of the common market were not sufficient to prevent that war. On the other hand, even the disruption of the war has not torn the common market completely asunder. Honduras has in effect destroyed the free trade aspect of the common market by establishing tariff restrictions against imports from the other four Central American countries equivalent to those against other countries. Nevertheless, Honduras continues to participate in the common market institutions--the secretariat (SIECA), the bank for economic integration (CABEI), and the stabilization arrangements. In fact, during my visit to Guatemala City, all five countries made additional $500,000 contributions to the stabilization fund.

Honduras felt that it was not gaining as much from the common market arrangements as the other countries. Specifically, the Hondurans felt they were merely buying more expensive industrial goods from neighbors without any, or at least sufficient, offsetting benefits. Also Salvadorians were employed in Honduras at the expense of Hondurans who tended to have fewer skills. This points out sharply the problem that free trade in and of itself within a common market is not sufficient to develop the less developed countries and areas. The bank (CABEI) has been giving preference to Honduras in "integration projects" but nevertheless the major increases in industrial production has taken place in Guatemala and El Salvador which were already more advanced economically. Honduras wants specific special concessions as part of the price of rejoining the common market. Whether the other cantries are willing to give Honduras special concessions remains to be seen, but it is interesting to note that the Andean Group has granted special concessions to its less developed members--in part as a result of the experience of Honduras in the CACM.

The CACM is a particularly revealing case since the gains from the common market seemed to reach their zenith--practically complete elimination of trade barriers on intra common market trade and a fourfold increase in such trade as a percent of total trade--just at the time of the war. What will happen now is anyone's guess, although it does look as though the common market has provided a force tending to pull the countries together. Whether this force is sufficient is the unanswered question.

The Andean Group

The countries of the Andean Group are: Columbia, Ecuador, Peru, Bolivia and Chile. Venezuela is a member of the bank only.

The Andean Group was established in 1969 as a subregional group, within the framework of LAFTA. The impetus came in part from the feeling on the part of the Andean countries that they were not gaining enough from LAFTA. One of the reasons given was that such a group would permit its members to bargain more effectively with the big three than would be possible separately.

The group drew heavily on the LAFTA experience and tried to structure their arrangements to try to avoid the weaknesses they saw in LAFTA. Therefore there are significant differences from LAFTA. The deadlines for specific changes are fixed and the group has taken particular pride in meeting its self imposed deadlines. (In the case of the investment code this insistence on meeting deadlines has had some unfortunate side effects, however.) Nevertheless, the importance placed on having deadlines and then meeting them is an indication of the activism of the group. Also, the tariff reductions are scheduled to take place automatically, with certain exceptions, rather than being handled on a more open case by case basis. Bolivia and Ecuador are granted specific concessions as less developed countries. The secretariat is receiving budget support from the member governments--in fact the budget for the Andean Group secretariat is already larger than that for LAFTA. From a technical standpoint the arrangements appear to be excellent. The key question is how well will they work out in practice--particularly in the current political climate. It is too early to tell at this point. The example of the investment code is about all we have to go by so far and it remains to be seen how the code will actually be applied.

The Carribean Free Trade Area (CARIFTA)

The members of CARIFTA are eleven English speaking members of the British Commonwealth in the Caribbean. This is also a very new development. CARIFTA was initially established in 1968 and has just recently put its free trade arrangements into effect--with certain exceptions.

The proposed entry of the British into the European Common Market has given the members of the Commonwealth in the Caribbean a real incentive to increase their cooperation in economic and trade matters since there is a real possibility that important markets for their exports in the United Kingdom will be lost unless the British can negotiate successfully with the EEC for the retention of these special arrangements. The loss of the UK markets for sugar, citrus and bananas would be a blow to the CARIFTA members. If the EEC price for retention of the special arrangements is reverse preferences i.e. preferences for EEC products in CARIFTA then this would present very real problems vis a vis the United States. Therefore the CARIFTA members feel caught in the middle and are trying to do what they can to broaden their economic strength within CARIFTA. This is far from an easy task, however. The Free Trade Area is small both in population and buying power. Also to date the more developed members such as Jamaica and Trinidad/Tobago seem to have benefited more from the free trade area than the others. CARIFTA has tried to take account of this by providing special measures to help the less developed smaller islands. (For example, only the smaller islands will receive loans on concessional terms from the bank). The CARIFTA members British experience does seem to tend to draw them together while the great distances separating the islands tends to draw them apart. Whether there will be enough cohesive force remains to be seen. Both the CARIFTA secretariat (actually the Commonwealth secretariat) and the bank staff are working to demonstrate the practical advantages of continued cooperation. So far the bank has been in existence only long enough to make its first loan but is beginning to show promise of becoming an important development institution. The bank can be particularly helpful in improving transportation and infrastructure which are vital to the development of the area.

CONCLUSIONS

The brief review of four Latin American free trade or common market arrangements suggests that there are some lessons to be drawn from their experience. Perhaps the most important is that economic integration in the form of a free trade area or a common market in and of itself is not sufficient for satisfactory economic development. It is an instrument of development but is not enough by itself. Unfortunately some of the more extreme "integrationists" and sloganeers have done a considerable disservice by claiming more than could be delivered. Also it is clear that a free trade area or a common market is successful where and to the extent that it is in the political interest of members to make it successful. Common economic interests act in the direction of drawing the members together but when any member sees enough political advantage to itself, it acts to obtain this advantage even if this will weaken (or even partially destroy) the free trade area or common market. The chances for progress tend to increase as political cohesion increases and decreases with diversity. It also looks as if large scale arrangements such as LAFTA have considerably less possibility for success than smaller groupings based on closer political and economic ties. Also while a common market or free trade area can provide a larger market for members' exports within the area through import substitution, this can only be carried so far and for the major gains necessary for continued rapid development, exports must be increased outside the area. The hard fact is that in order to obtain the resources necessary for development a country must export to the developed countries--especially to the US, the EEC and/or Japan. Therefore, to the extent that the common market or free trade area permits improved efficiency through economies of scale and develops exports that are competitive outside the area, it is useful. To the extent the common market or free trade area merely permits the substitution of higher cost goods for low cost goods without increased productivity and efficiency, it is counterproductive. Profits for individual enterprises may be increased in the latter case but the consumer gains nothing and there is no development payoff. Finally, the size of the market appears to be less important than the quality of the market--in terms of the political situation, levels of income, skills of the people, institutional environment, availability of infrastructure, government policies and practices, and the degree of risk.

The prospects for success for a common market or free trade area seem to be significantly improved if the trade aspects are complemented by the following:

1) a development bank

   a) as a conduit for external and internal financing
   b) as a source of technical assistance

2) arrangements to coordinate and rationalize fiscal and monetary policies

3) means to improve and coordinate planning for development (including complimentary sector planning)

4) steps to improve physical integration (especially infrastructure and transportation)

Economic integration can make a useful contribution to economic development. It can be particularly valuable in focusing the attention of the members on what they can do for themselves and each other.