

What if the FTAA fails? The Future of Free Trade in Latin America

General Interest and Trends

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The original goal of a comprehensive hemispheric Free Trade Area (FTAA) will not likely be achieved within its original timeframe. The reasons range from US intransigence concerning agricultural trade to more democratic political structures in many Latin American governments that lengthen and often complicate the ratification process. The spirit of naïve optimism associated with Free Trade in the Americas in the 90's has been replaced by pragmatism where free trade agreements are downsized to a more realistic level. In the Americas, a series of free trade initiatives are in play that ultimately may prove to be just as effective as the increasingly elusive FTAA.

Resistance to a full-fledged FTAA has not reduced the region's thirst for free trade. Latin American governments, while increasingly sensitive to populist sentiments at home, are cognizant of the growth and stability that the last decade has delivered to the region's free-traders, Chile and Mexico. The two countries stand out as the only ones in the region to see steady wealth creation over the last eight years. In both cases, above-average FDI and trade levels generate a steady flow of international currency that has lowered their foreign debt burdens and enabled investment grading, creating huge savings on debt servicing. As a result, both countries are the envy of the rest of the region.

Free Trade Initiatives in Play

In motion today are five trade initiatives in the Americas that international businesses need to monitor. FTAA lite is the scaled-down proposal that was presented in Miami in November, 2003 when the ministers last met to discuss the agreement. This watered-down version sidesteps many of the agricultural issues that stood in the way of ratification by the US Congress. Conversely, the Latin American signatories will not be bound to strict enforcement of intellectual property and other non-trade provisions that some countries – especially Brazil – considered un-sellable. In spite of this backtracking, the proposed agreement would still bring significant change to the region in terms of the production and trade of manufactured goods.

As early as 2001, the Bush administration wanted to back away from the "FTAA or nothing" strategy promoted by the Clinton administration. It started by waving the carrot of bilateral agreements with mid-size economies in Latin America. For example, the Chile-US trade agreement wooed Chile away from full and binding membership in Mercosur. Now the Central American Free Trade Agreement (CAFTA) has been signed. Its passage through the US Congress in an election year will require careful choreography and the agreement may not make it to a vote in 2004. Nonetheless, if delayed or denied in 2004, it is likely to pass in 2005. CAFTA would hasten the necessary consolidation of industry within Central America and spur foreign investment there. A successful CAFTA would also

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lead to other such agreements with Colombia, Peru, and Ecuador possibly leading to the next sub-regional agreement with the US.

As the promise of access to US agricultural markets continues to be denied through stalling in the Doha round of the WTO and at the FTAA level, Brazil and Argentina have resumed negotiations towards building a larger and deeper version of Mercosur. There is now talk of an economic union akin to the EU. Such grandiosity may not be realistic. Nonetheless, political support is in play for a stronger union among the existing Mercosur members as well as a tighter relationship with Chile, and a deal with the Andean Community. Mercosur began the rationalization process within the industrial corridor that runs from Rio de Janeiro to Buenos Aires. A stronger agreement would further consolidation.

The growing animosity between Argentina and the US and to a lesser degree between Brazil and the US has given credibility to the longstanding proposal to create an EU-Mercosur trade agreement. The political climate may now be warm enough to overcome the large differences on agricultural trade between the two regions. If an agreement can be signed and ratified, the impacts on European investment in Brazil and Argentina will be significant.

Impact on the Region

The combination of free trade initiatives presently on the table will accelerate the process of industrial rationalization that began in earnest with the NAFTA and was advanced to a lesser degree by an imbalanced Mercosur. As national-scale industry gives way to regional integration, intra-regional trade will grow. Moreover, well-designed trade pacts will foster business confidence and drive foreign investment, opening new opportunities and raising competition levels to global standards. Latin America currently has two important cross-border industrial hubs: Northern Mexico-US and Buenos Aires-S.E. Brazil. New agreements that further reduce trade barriers will create more, albeit smaller, industrial hubs, such as IT in Costa Rica, Banking in Panama, and Plastics in Colombia.

The disparate geographies and inefficient transport infrastructure of Latin America do not lend themselves to regional integration, the original goal of the FTAA. Latin America historically trades in far greater volumes with partners outside of the region than with its own neighbors. Behind this trade structure is the fact that Latin America exports primarily commodity materials and low-cost labor-intensive assembly products, both of which enjoy healthy demand in the world's wealthy economies. Conversely, Latin America is a net importer of technology and business services that are best sourced from outside of the region.

Bringing down trade barriers in Latin America will rationalize some industries that have developed side-by-side in protected enclaves. The auto sectors of Brazil and Argentina have consolidated to some degree thanks to Mercosur. NAFTA has been even more effective at rationalizing North America's automotive and industrial electronics sectors. Certainly Central America's retail, food production and transport sectors are ripe for consolidation. Rationalization is possible between Venezuela and Colombia's parallel chemical & plastic industries.

A more significant impact on the region, however, will be a push towards greater specialization of Latin America's industrial landscape. Brazil and Colombia, both relatively protected and diversified economies, head the list of countries that face the greatest changes ahead. Both countries continue to protect and subsidize weak industries which advance a strategic goal (high-tech) or employ large volumes of low-skilled labor (assembly). The removal of the Caribbean's protection of the beer and food industries will dismantle those industries. Other cases of costly protectionism will be the first victims of freer trade. On the other hand, forcing these industries to consolidate or perish will save consumers and governments billions of dollars, generating wealth through greater specialization.

The most promising economic benefit expected from the free trade agreements now on the table is the influx of foreign direct investment that regional agreements facilitate. As much as Mexico, Chile and Costa Rica have benefited from increased trade, it is FDI that has transformed these economies into modern, competitive exporters. The transfer of capital, technology and know-how provide the seeds for future growth in a region that has historically failed to retain its citizens' savings or to develop new technologies, suffering a tremendous brain drain as a result. FDI is the ultimate catalyst of modernization because it forces upon local companies unprecedented levels of competition. No government-sponsored industrial policy can boost productivity in Latin America as much as the entry of foreign rivals.