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The Case of MERCOSUL

Leonardo Campos Filho

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Leonardo Campos Filho

Institute of Latin American Studies
31 Tavistock Square London WC1H 9HA

Leonardo Campos Filho is an economist in the Import and Export Division of the National Agency for Oil – Rio de Janeiro. He completed his PhD in Economics at the Institute of Latin American Studies in 1998.

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New Regionalism and Latin America: The Case of MERCOSUL*

Leonardo Campos Filho

The focus of this paper is the new attempt at regional integration undertaken by Argentina, Brazil, Paraguay and Uruguay. The pursuit of integration is examined in the light of recent developments both at a world level and in the rest of Latin America. The motivations behind the scheme are analysed and its achievements and shortcomings are evaluated. The first section describes the recent worldwide surge in regionalism. Section two summarises the main contributions from economic theory that provide the basis for the analysis in subsequent sections. Section three focuses on the motivations behind the new regionalism and its potential implications for the world economy. Section four turns to the nature of recent economic integration in Latin America and makes some comparisons with previous attempts. Section five evaluates the experience of MERCOSUL. Section six presents a quantitative analysis of recent trends in trade flows for MERCOSUL countries. In the final section, some tentative conclusions are drawn.

The Recent Pursuit of Regionalism: A World Perspective

Policy-makers and many economists will certainly remember the late 1980s and early 1990s as an era marked by the rebirth of regionalism. As Melo and Panagariya (1992) put it:

> Today regionalism is back with a vengeance. In its current incarnation, regionalism has engulfed all major players in the world economy. Division of the world into three trading blocs – never an issue in the first round – is being debated seriously. Confidence in the GATT process is on the decline, and enthusiasm toward the regional approach on the rise. Most notably, the United States – an ardent defender of the multilateral approach and the most formidable opponent of regionalism in the 1960s – has become an active perpetrator of regionalism.[1]

Table 1 presents a series of regional trade arrangements (RTAs) notified to GATT (General Agreement on Tariffs and Trade) since 1947.[2] However, before

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* MERCOSUL is the Portuguese acronym for South American Common Market. Its Spanish acronym is MERCOSUR.

1 Melo and Panagariya (1992), p. 2.

2 The author distinguishes RTAs from preferential schemes and association agreements. Preferential schemes account for non-reciprocal tariff reductions agreed between developed and developing countries – e.g. the Lomé Convention, whereby the European Union (EU) offers preferential treatment for imports coming from some African, Asian and Pacific countries. Association agreements are, in most cases, reciprocal agreements signed by an RTA and a specific country, extending free trade area treatment to a particular range of goods and services. For example, in 1992, an association agreement linked Turkey to the EFTA countries. See GATT (1995).

proceeding with the analysis, I shall comment on the relationship between GATT and regional trade arrangements.

GATT was established in 1947 with the objective of promoting multilateral negotiations towards dismantling protectionist measures. GATT negotiations rest on the concept of non-discrimination embodied in the most-favoured-nation clause, which guarantees that all contracting parties receive from each member treatment similar to that offered to the most favoured partner. In contrast, RTAs entail discriminatory preferences for imports coming from distinct countries, and thus they are obliged to comply with Article XXIV of GATT, which deals with customs unions and free trade areas.[3] A free trade area implies the elimination of tariff and non-tariff barriers among members, who retain their individual trade policies regarding non-member countries and apply rules of origin for regional imports.[4] Customs unions entail not only the abolition of obstacles to trade among participants, but also the adoption of a common external tariff (CET) for trade with non-members.[5] To be consistent with Article XXIV, regional trade arrangements should comply with two major principles. Firstly, 'substantially all' trade among participants of either a free trade area or customs union should be liberalised. Secondly, within a customs union, the CET should not be higher than the average tariff levied by member countries prior to the union. The first principle was envisaged to allow exceptions to the most-favoured-nation clause only when the RTAs aimed to reduce almost all mutual tariffs to zero. The second would ensure that the move towards an RTA was not intended to raise the levels of protection against the rest of the world (ROW). Ambiguities in the interpretation of legislation and the lack of enforcement powers have greatly weakened the application of GATT rules.[6] In fact, the record of the past fifty years suggests that GATT's evaluations of regional arrangements were, to a large extent, ineffective. As Lloyd (1992) pointed out:

> Of the more than 70 arrangements under Article XXIV which have been reviewed by the GATT, only four were declared fully compatible with the Article.... However, no agreement was declared incompatible with the Article.[7]

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[3] After 1979, GATT exempted regional trade agreements created by developing countries from meeting the Article XXIV criteria.

[4] Rules of origin state the requirements that must be met for regional imports to be given duty-free treatment. They are devised to deter extra-regional imports entering a high tariff member through a low tariff country.

[5] Apart from free trade and customs unions, RTAs may evolve to common markets and economic and monetary unions. In a common market, one has all the elements of a customs union plus free labour and capital mobility. An economic union is a common market with a common currency and common macroeconomic policies.

[6] See Bhagwati (1993a).

[7] Lloyd (1992), p. 27.

Table 1 - Regional Trade Arrangements Notified to GATT, 1947-92

Title	Members	Year signed
France-Italy Interim Customs Union (incorporated into the EC in 1957)	France, Italy	1947
South African-Southern Rhodesian Customs Union	South Africa, Southern Rhodesia	1948
Nicaragua and El Salvador Free Trade Area (incorporated into the Central American Free Trade Area in 1958)	El Salvador, Nicaragua	1951
European Coal and Steel Community (incorporated into the EC in 1957)	Belgium, France, Italy, Luxembourg, Netherlands, West Germany	1951
European Economic Community (including European Atomic Energy Community)	1. Original Members: Belgium, France, Italy, Luxembourg, Netherlands, West Germany 2. Denmark, Ireland, United Kingdom joined in 1973 3. Greece joined in 1983 4. Portugal and Spain joined in 1986	1957
Central American Free Trade Area (incorporated into the Central American Common Market in 1960)	Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua	1958
European Free Trade Association (EFTA)	1. Austria, Denmark, Norway, Portugal, Sweden, Switzerland, United Kingdom 2. Denmark and United Kingdom seceded and joined the EC in 1973 3. Iceland acceded in 1970 4. Finland became a full member in 1970 5. Portugal seceded and joined the EC in 1986	1960
Latin American Free Trade Area (replaced by the Latin America Integration Association in 1980)	1. Argentina, Brazil, Chile, Mexico, Paraguay, Peru, Uruguay 2. Colombia and Ecuador acceded in 1961	1960
Central American Common Market	Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua	1960
Arab Common Market	United Arab Republic	1964
Central African Economic and Customs Union	Central African Republic, Chad, Congo (Brazzaville), Gabon	1964
Canada-US Automotive Agreement (incorporated into Canada-United States Free Trade Area in 1988)	Canada, United States	1965

Table 1 Continued

Title	Members	Date signed
Australia-New Zealand Free Trade Agreement (replaced by the Australia-New Zealand Closer Economic Relations Agreement in 1993)	Australia, New Zealand	1965
United Kingdom-Ireland Free Trade Agreement (incorporated into the EC in 1973)	Ireland, United Kingdom	1965
Caribbean Free Trade Agreement (replaced by the Caribbean Community and Common Market in 1974)	Barbados, Guyana, Trinidad and Tobago	1968
Andean Pact	1. Bolivia, Chile, Colombia, Ecuador, Peru 2. Venezuela joined in 1973 3. Chile seceded in 1976	1969
Caribbean Community and Common Market	1. Barbados, Guyana, Trinidad and Tobago 2. Other countries joined in 1974	1973
ASEAN Preferential Trading Arrangements	1. Indonesia, Malaysia, Philippines, Singapore, Thailand 2. Brunei joined in 1988	1977
Latin American Integration Association	Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Mexico, Paraguay, Peru, Uruguay, Venezuela	1979
Australia-New Zealand Closer Economic Relations Trade Agreement	Australia, New Zealand	1983
Free Trade Agreement between Israel and the United States	Israel and the United States	1985
Single European Act (replaced the European Coal and Steel Community, the European Economic Community and the European Atomic Energy Community)	Belgium, France, Greece, Italy, Luxembourg, Netherlands, Portugal, Spain, United Kingdom, West Germany	1986
Canada-United States Free Trade Area	Canada, United States	1988

Note: These arrangements were notified under Article XXIV or in a few cases Article I or other articles. The table does not include preference schemes and association agreements notified to GATT

Source: GATT, *Basic Instruments and Selected Documents*, Supplements 1-36. GATT Activities, various issues, extracted from Lloyd (1992).

Table 1 surveys the main RTAs established since the creation of GATT.[8] Four distinct phases can be distinguished over the fifty-year period. Firstly, between 1947 and 1957, the relatively few RTAs created were among bordering

[8] The list does not incorporate some of the RTAs between developing countries, which, after 1979, did not need GATT notification and those among non-GATT members. For a recent appraisal of RTAs, see WTO (1996).

countries, and, in the case of the European Coal and Steel Community, covered specific sectors. The second period started with the establishment of the European Economic Community (EEC) in 1958. Following the creation of the EEC, a wave of integration schemes spread throughout other parts of the European continent, Latin America, Africa, and the Middle East. Notably, three regional schemes were created in Latin America; by 1969, almost all countries in the region were members of one of these schemes. In Africa an RTA was created between Central African countries, and in Europe the European Free Trade Area (EFTA) was established. By the early 1970s, this process of regionalism had slowed down. From 1970 to the early 1980s, only one new RTA was notified to GATT. In Latin America, some RTAs changed their status; as was the case with the Latin America Free Trade Area (LAFTA) which was replaced by the Latin America Integration Association (LAIA). Moreover, there was an increase in the number of participants within the Caribbean Community. In Europe, the EEC continued its dynamic growth with the accession of the UK, Ireland and Denmark in 1973, and of Greece in 1981. Finally, the first RTA (ASEAN) was established in Asia.

The fourth phase of regionalism began in the mid-1980s, bringing a new wave of RTAs. In Europe, there was a continual widening of the original EEC. Portugal and Spain acceded in 1986. In 1995, Austria, Sweden, and Finland joined the EU.[9] In 1991, EFTA countries signed an agreement with the EC, effectively linking the two arrangements.[10] In North America, the impulse towards regionalism reached new heights. Following the creation of a free trade agreement with Israel, the United States established a fully-fledged free trade agreement with Canada in 1989. More recently, in 1994, the North American Free Trade Agreement (NAFTA) was set up between the United States, Canada and Mexico.

Renewed efforts towards regional integration were also initiated in Latin America. In 1989, the Andean Pact was revived with the signature of the Quito Protocol.[11] In 1991, Argentina, Brazil, Paraguay and Uruguay set up the South American Common Market (MERCOSUL). The Central American Common Market (CACM) also received a new boost. The return of peace and a more stable political environment in Central America sparked off several initiatives, bringing the quest for regional integration back to the fore.[12] Moreover, an impressive network of bilateral free trade agreements, linking a number of countries and regional schemes, has also been established throughout the region.[13] In addition, agreements that would encompass the entire hemisphere

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9 The term European Community (EC) referred to the European Atomic Energy Community, European Economic Community and the European Coal and Steel Community. After 1992, the EC was renamed the European Union (EU). For a recent account of regional schemes, see Lawrence (1996) and WTO (1996).

10 The agreement between EFTA countries and the EC has created an extensive free trade area that includes free circulation of goods, services, labour and capital. See Lawrence (1996).

11 See Garay (1992).

12 See Nogues and Quintanilla (1993), Lizano (1992) and Bulmer-Thomas (1992).

13 Between 1990 and 1996, Chile signed free trade agreements with Mexico, Argentina, Bolivia, Venezuela, Ecuador and MERCOSUL. Mexico signed agreements with Chile, CARICOM, Costa

have been discussed. In 1990, the Enterprise for Americas Initiative, launched by the US administration, provided the framework for negotiating free trade agreements across the entire American continent. During the 1994 Americas Summit held in Miami, the thirty-four participating countries agreed to commence talks on a free trade area for the Americas. In Asia, ASEAN has been revived, with members agreeing to the formation of a free trade area by 2007. Several countries of the Pacific Rim have recently launched the Asia-Pacific Economic Cooperation (APEC) Forum with a view to extending cooperation and the promotion of trade and investment.

It should be borne in mind that the proliferation of RTAs does, in many cases, overstate the extent to which tariffs and non-tariff barriers have been eliminated. In the 1960s, for example, the pursuit of regional integration by developing countries did not bring any significant reduction of trade barriers. The impact upon regional trade flows was only temporary and, on some occasions, barely discernible.[14] Even in the case of integration among developed countries, for example the United States and Canada Automotive Agreement and the Australia and New Zealand Closer Economic Relations Trade Agreement, trade liberalisation did not extend beyond specific sectors. The case of the EU is possibly the only undisputed case of a broad regional arrangement where barriers to trade were, to a large extent, eliminated and intra-regional trade, as a proportion of the total trade, experienced a significant increase.[15]

A comparison between recent and past waves of regionalism reveals some new features. As Lloyd (1992) noted, today's regionalism has, in most cases, 'deepened' the scope of integration.[16] Apart from the dismantling of tariff and non-tariff barriers, the participating countries have begun to consider the elimination of measures that, although not directly related to trade, hinder the free circulation of goods, services and factors of production. In this respect, the progressive widening of the original EEC has also been accompanied by the extension of liberalisation and harmonisation in many new areas.[17] Following the abolition of tariffs and many non-tariff measures, the EU has proceeded to harmonise technical norms and standards or enforce mutual recognition of regulatory frameworks. Other 'non-border' obstacles such as restricted access for foreign firms to government procurement, market access limitation for foreign firms and individuals in many services and professions, discriminatory domestic taxes and quantitative barriers were also eliminated. It is worth noting that the discriminatory nature of such 'non-border' measures grows in

Rica, Bolivia, Colombia and Venezuela. Argentina signed agreements with Chile, Bolivia, Venezuela and Ecuador. Bolivia signed agreements with Uruguay, Argentina, Peru, Chile and Brazil. Finally, agreements between CACM and Mexico, CARICOM and Venezuela, Colombia, Mexico and Venezuela have been also signed. See Fuentes (1994), Lawrence (1996) and *Financial Times* (several issues).

14 See Langhammer (1992) and WTO (1996).

15 See Melo and Panagariya (1992), WTO (1996) and Winters (1993) for a critical analysis of the EU.

16 See also Lawrence (1996).

17 Many of these issues were broached by the Single European Act in 1986, which proposed the establishment of the 'Single Market' by 1992.

importance when trade-related obstacles are eliminated. Thus, it becomes essential to tackle these barriers to ensure the full benefits of competition.[18]

This trend has also found a parallel in North America. The United States-Canada sectoral agreement of 1965 evolved into a fully-fledged free trade area in 1989. This agreement embodied not only the pursuit of free trade in goods and a range of services, but also preferential treatment for investors from both countries and an effort to liberalise government procurements. The establishment of NAFTA in 1994 greatly emphasised the relative importance of such issues. Provisions for the liberalisation of cross-border investment within a wide range of services were introduced and provisions made for the further liberalisation of access to government procurement.[19] In addition, NAFTA led to peripheral-agreements on environment and labour standards. The Australia-New Zealand Treaties were also considerably deepened. Not only was free trade in goods, services, labour and capital pursued and achieved in the late 1980s, but also the substantial liberalisation of non-border measures. A competitive regional policy and mutual preference in government procurement were also put into effect. Furthermore, an explicit commitment to the harmonisation of many standards was also stressed.[20] In the case of developing countries, the new efforts towards integration have not substantially dealt with such 'non-border' issues.[21] Nevertheless, there is evidence that the regional agreements are heading for more trade liberalisation. For example, in Latin America, generalised across-the-board tariff reductions are now more often seen than the adoption of positive lists, where liberalisation occurs only in specified products. Another aspect of the new regionalism representing a break from the past was the widening of schemes, created by developed countries, to encompass low-income bordering partners. In Europe, the EC was expanded to include Portugal, Spain and Greece; in North America, Mexico acceded to NAFTA.

Theory of International Integration: Some Considerations[22]

Jacob Viner's 1950 contribution to this field is the cornerstone of economic analysis of the effects of regional arrangements on welfare. Viner (1950) identified two effects associated with the formation of a customs union. Firstly, there may be trade creation, where supply is shifted from high cost domestic producers towards a low cost source within the union. Secondly, there may be trade diversion, which entails the shift of supply from a low cost source outside the union towards a high cost producer established within the union. Trade creation enhances efficiency and welfare by orienting scarce resources according to each country's comparative advantage. In turn, trade diversion curbs

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18 However, as noted later in the text, the quest for the harmonisation of policies and standards does not necessarily guarantee that the outcome will be less restrictive and more efficient. For example, RTAs may also adopt complex common standards, so as to shelter domestic firms from extra-regional competition.

19 NAFTA also strengthened a dispute settlement mechanism previously included in the Canada-US agreement. See Lawrence (1996) and WTO (1996).

20 See Lawrence (1996).

21 See Fuentes (1994) for the case of Latin America.

22 For a comprehensive survey on this issue, see Hine (1994).

efficiency and welfare by diverting resources from their most efficient use. A customs union is said to be welfare-improving when trade creation exceeds trade diversion.[23] Ruling out terms-of-trade effects, a net welfare-enhancing customs union leads to an improvement in world welfare.

Post-Vinerian literature greatly relied on models based on two goods and three countries. Two countries are potential partners (home and foreign) and the third represents the rest of the world (ROW). Potential partners import different goods. The home country is taken to be small and thus faces an infinitely elastic supply of imports and demand for exports. Perfect competition prevails with the production of homogeneous goods under increasing marginal cost. Figure 1 presents the partial equilibrium analysis following the formation of a customs union that entails the elimination of protection on the partner country's imports and maintenance of existing tariffs on ROW imports. When tariffs are levied on imports coming from all sources, the domestic price of imports (including the tariff) is *p3*, which leads to a total demand of *q3*. Imports are represented by the distance *q2q3*, the difference between domestic production and demand. Tariff revenue can be measured from the areas *e* and *g*, which can calculated by multiplying imports by the difference between domestic and world prices. Given that the ROW is the most efficient source, domestic consumers will purchase all imports from ROW producers. Following the formation of a customs union, the tariff on partner imports is eliminated and the domestic price falls to *p2*. Domestic consumption rises to *q4* and domestic production falls to *q1*, with imports increasing to *q4q1*. The partner country now supplies all imports purchased in the home country.

Consumer surplus increases by the total area ($c + e + d + f$), where c is a transfer from producers and e tariff revenue forgone. Benefits from trade creation can be assessed by areas d and f, which are the net consumption and production gains from a rise in imports where the least efficient domestic source is displaced. It should also be noted that there is a shift of *q2q3* in imports away from ROW (the most efficient source) towards the partner country. This amounts to trade diversion, and the associated loss in welfare can be assessed by area g, which is the additional cost incurred in the home country for acquiring *q2q3*. From the importing country's point of view, this area is also equal to the loss in customs revenue. Net welfare gains or losses occur, having taken into account the impact on consumer and producer surplus and tariff revenue. Given that the total loss in tariff revenue equals ($g + e$) and the fall in producer surplus is equal to c, the change in net welfare can be calculated as ($d + f$) - g. Hence, there is no *a priori* hypothesis regarding gain or loss from integration; which means that welfare changes should be sensitive to the values of demand and supply elasticities, domestic tariffs and the difference between the partner and ROW prices. Thus, the study of the impact of regional schemes is often

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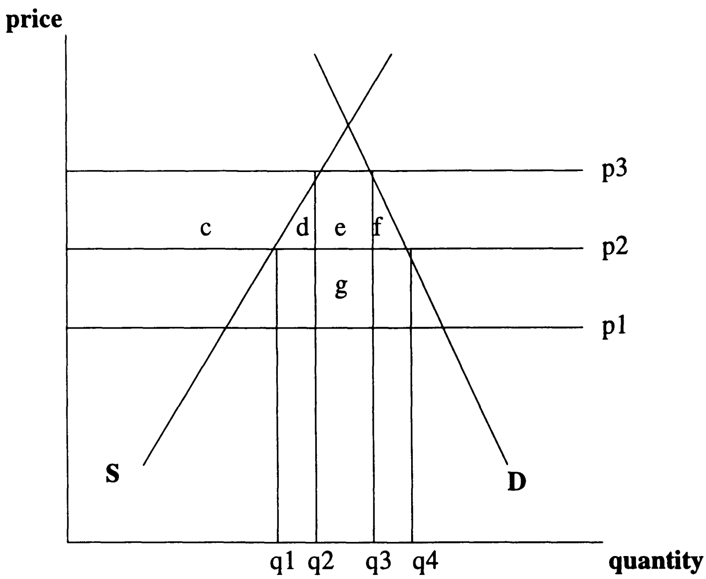
23 In Viner's original analysis, inter-commodity substitution was not allowed and this limited the consumer gains accrued from the formation of a custom union. When this paper refers to trade diversion and trade creation, following post-Vinerian literature, both production and consumption effects are considered. See Lipsey (1960).

presented as an application of the theory of second best.[24] This theory points out that if it is not possible to fulfil all the necessary conditions for the maximisation of welfare, a move towards the fulfilment of some conditions may make things better or worse. In the case of a customs union, given that worldwide free trade is ruled out, having free trade with a specific set of partners does not necessarily improve welfare.

Figure 1 - Customs Union: Partial Equilibrium Analysis



where:
p1 = world price
p2 = regional partner price
p3 = domestic price
q1 = domestic production after RTA
q2 = domestic production before RTA

Despite the absence of general hypotheses, there are some factors that may enhance the possibility of trade creation and/or narrow the scope for trade diversion. A customs union will be conducive to trade creation when members have a similar range of protected sectors which, in turn, present significant cost differences across the union. Trade diversion may be less widespread if actual trade flows account for a small proportion of production and a large percentage of existing trade is with a future partner.[25] A customs union will also curb potential trade diversion when it incorporates many partners and the CET is set below the level prevailing prior to integration.

24 See Lipsey and Lancaster (1956).
25 See Hine (1994) and Lipsey (1960).

When the assumption of a small open economy is dropped, a situation may be envisaged in which countries gain from enhanced terms of trade following the formation of a customs union.[26] Where the forces of trade diversion are strong and members are large, the reduction in the demand for imports from the rest of world will lower prices. Assuming balanced trade, exports are diverted from the rest of the world in order to pay for increasing regional imports, and this should shift their prices upward. As a result, the union will benefit from improved terms of trade to the detriment of the rest of the world. Such gains from terms of trade can be extensive and offset the cost of trade diversion. They are, however, greatly curtailed by the potential losses associated with retaliation. Provided outside partners raise their barriers on exports from the union, these gains are likely to turn into losses for all countries. The terms of trade argument can also be presented within a context in which it does not necessarily imply a net loss for the ROW. Regional integration may entail the strengthening of bargaining power within international negotiations, and influence the imposition of tariff and non-tariff barriers upon its members. Here, the formation of RTAs would enhance their members' terms of trade by avoiding the negative effects derived from other countries' barriers to trade. The threat of joint retaliation from a group of partners would act as a deterrent to outsiders seeking to raise protection.[27] An RTA may also enable member countries to strike better deals for bilateral tariff reductions than they ever could with each acting on their own account. Gains from enhanced bargaining power are likely to be proportional to the economic size of the regional arrangement *vis-à-vis* the ROW. Thus, not all attempts at integration will be successful in acquiring such benefits.

Particularly important to our analysis is the literature evolving from Viner's work that has investigated the economic rationale that motivates countries to engage in regional schemes instead of supporting unilateral liberalisation.[28] Using the standard assumptions outlined above, one can show that non-preferential trade liberalisation could secure the benefits of trade creation, without the harmful effects of trade diversion.[29] Thus, unilateral (non-preferential) trade liberalisation would generate more welfare gains than a customs union. The justification for integration, under these circumstances, would then relate to the achievement of non-economic objectives. This line of reasoning is nevertheless considerably weakened when the standard assumptions are modified. When one assumes that all parties have tariffs, transportation costs are not zero and a movement towards a customs union entails a fall in tariffs on

[26] See Mundel (1964) for the original formulation of the possibility for mutual benefits from improved terms of trade within a customs union. It is worth noting that the hypothesis that customs unions enhance their members' terms of trade *vis-à-vis* the outside world depends greatly on the assumptions of the model. One example is where the terms of trade of the ROW improve *vis-à-vis* the union.

[27] For example, there is evidence that the threat of retaliation from the EC has restrained the United States from applying anti-dumping measures and countervailing taxes upon its members. It has not, however, prevented the United States from imposing such measures on individual countries such as Japan, India and Brazil. See Melo, Panagariya and Rodrik (1993).

[28] Melo, Panagariya and Rodrik (1993) offer a recent survey on the issue.

[29] See Cooper and Massell (1965).

exports from the home country, a customs union may provide additional benefits not matched by unilateral liberalisation.[30] The key issue here is that the existence of transportation costs and tariffs in the ROW reduces the terms of trade it could offer to union members.[31] Hence, this opens up the possibility that a customs union will offer terms of trade unattainable in unilateral trade liberalisation. Naturally, this outcome will be more likely in a world where tariff barriers are high and most economies are relatively closed to trade.[32]

The standard theoretical framework and most of the quantitative studies referring to international integration focus on the potential gains from specialisation based on static comparative advantage. Other sources of potential gains have, however, been given increasing attention. Since the late 1970s, a growing number of studies have attempted to shed light on the benefits of economies of scale, product differentiation and increasing competition in product markets.[33] Enlarging markets may now lead to gains from the process of industry rationalisation,[34] reduction of monopolistic rents, increased product variety and the promotion of technical efficiency. Developments in growth theory have recently provided evidence of the dynamic positive effects of trade openness. The new body of theory emphasises the endogenous nature of technological progress and positive effects of trade openness on the incorporation of new technology embodied in goods and services. In this context, regional integration may buttress growth rates by fostering trade in new capital goods and by allowing the cost of research and development to be spread over many countries.[35] Lastly, the recent trend towards the dismantling of 'non-border' measures and the harmonisation of policies and standards has raised several pertinent questions relating to the impact of integration. Here, the application of the traditional theoretical framework has visible limitations. As Lawrence argued, while the traditional framework focuses mainly on changes in prices, these issues call for specific tools to gauge the impact of changing rules and institutions.[36]

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30 See Wonnacott and Wonnacott (1981).

31 Tariffs and transportation costs in the ROW will reduce the price of exports in relation to imports.

32 See Hine (1994) and Melo, Panagariya and Rodrik (1993).

33 The relationship between economic integration and economies of scale has been identified in many previous works, including Viner (1950). Corden (1972) made a detailed examination of the effects manifested when economies of scale, internal to the firm, are introduced. The author distinguished two new effects arising from the formation of a customs union. Trade suppression occurs when, after the formation of the customs union, domestic firms now produce a commodity that was previously imported. Cost reduction means the decline in average cost due to increasing scale. In general, the former, like trade diversion, reduces welfare and the latter improves it.

34 Here, industry rationalisation refers to the fall in the industry-wide average cost. Given the presence of economies of scale, this can occur due to rising output across all firms or shifting market shares toward larger and more efficient firms. See Roberts and Tybout (1991) for a comprehensive analysis.

35 See Melo, Panagariya and Rodrik (1993), Baldwin and Venables (1995), and Hine (1994) for an analysis of dynamic effects.

36 See Lawrence (1996).

New Regionalism: Motivations and Controversies

By the early 1990s, the disillusionment concerning multilateral trade liberalisation under the auspices of GATT was the main reason underlying the new burst of regionalism. Despite the achievements of post-war years, during which time the successive GATT negotiations managed to cut considerably tariffs on manufactured goods,[37] the multilateral approach began to run out of steam. In particular, the so-called new protectionism of the mid-1970s and early 1980s emerged as a clear threat to the previous achievements of GATT. The nature and extent of this new protectionist movement was well summarised by Salvatore (1993):

> The instruments by which imports are restricted are also somewhat different from, and less transparent than, traditional import tariffs, and are called non-tariff barriers (NTBs). These refer to 'voluntary' export restraints, orderly marketing arrangements, anti-dumping measures, countervailing duties, safeguard codes and so on. Thus, at the time when tariffs were being reduced as part of the successive rounds of trade liberalisation sponsored by the GATT and they are presently very low on most industrial goods, the number and importance of NTBs have grown rapidly since the mid-1970s and they have now become more important than tariffs as obstructions to international trade. As much as 50 per cent of world trade is now affected by this new protectionism.[38]

The resurgence of protectionism within the developed world was, in part, a result of severe recession, under which unemployment in the United States and Western Europe soared in the early 1980s.[39] The usual troublesome domestic adjustments, associated with rising imports, were made even harsher by sluggish growth rates and mounting idle capacity. In this respect, barriers to trade were frequently adopted to curtail growing imports from Newly Industrialising Countries (NICs).[40] As discussed below, the latter group of countries includes many East Asian countries, which have been particularly successful in exporting labour-intensive manufactured goods.

The dissemination of NTBs was already a concern when the Tokyo Round of GATT negotiations took place in Japan between 1974 and 1977. Nevertheless, no effective set of norms was agreed upon to deal with their spread.[41] There are major difficulties concerning the control of these restrictive practices by GATT. In many circumstances, NTBs are applied to protect domestic firms from predatory foreign competition. Dumping from foreign firms and/or export subsidies are often said to raise foreign competitiveness in domestic markets and harm national competitors. The problem, however, lies in the fact that GATT

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37 See Kenen (1994).

38 Salvatore (1993), p. 1.

39 As Corden (1993) noted, recession may bring rising trade barriers, but prosperity does not necessarily reduce such barriers to their initial levels. Strong domestic lobbying may ensure that, once established, such obstacles will be sustained although the initial cause may long since have passed.

40 See Helleiner (1993).

41 Nevertheless, new codes of conduct for import valuation issues and government procurement were, though with many exceptions, agreed upon during the Tokyo Round, see Kenen (1994).

rules did not precisely define predatory behaviour, meaning that standard business practices may have been taken to be 'unfair'. On the other hand, some NTBs, such as subsidies and tax benefits for key industries, are considered by governments to be part of their spectrum of domestic policy tools. Consequently, they do not see a role for international agreements and GATT involvement.[42]

A new round of GATT negotiations was convened in 1985 to stop the rise of protectionist pressures. The Uruguay Round of multilateral negotiations began in 1986, with many controversial issues on the negotiation agenda. On the one hand, large exporters of temperate-zone agricultural commodities were pushing for the opening up of Japanese and European markets. In this context, a bitter impasse emerged between the United States and the European Community over the European Common Agricultural Policy (CAP).[43] On the other hand, developing countries, especially the NICs, wanted to see a cut in non-tariff barriers which were particularly harmful to their manufacturing exports. The United States and other developed countries expected to obtain a worldwide agreement on intellectual property and more open trade in services.[44] After seven years of negotiations, the Uruguay Round came to an end in December 1993, and agreements were successfully reached on a wide range of topics. Some of the most troublesome issues were tackled, such as trade in agriculture and textiles. Furthermore, GATT was replaced by the World Trade Organisation (WTO), with greater autonomy to settle disputes among contracting members.[45] Nevertheless, the long and uncertain implementation periods of many provisions have given some grounds for caution. In agriculture, for example, the agreement stipulated a phase-out period of six years for the reduction (not elimination) of subsidies. In the case of textiles, non-tariff barriers will be lifted only at the end of 2003. Likewise, a period of ten years was given for the implementation of the agreement on intellectual property. The general agreement on services omitted key activities, such as financial and telecommunication services.[46] New rounds of negotiations were scheduled for dealing with these sectors. Regulations for trade-related investment measures were agreed, but their scope was still limited. The lack of precision and enforcement of GATT rules on regional arrangements has not been remedied and an overhaul of such rules is not on the current agenda of the WTO.[47]

By the early 1990s, the outlook of a world trade system threatened by growing protectionism and uncertainty regarding multilateral negotiations led some to see regionalism as an alternative track for trade liberalisation. The

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[42] See Salvatore (1993).

[43] The latter provides not only protection for agricultural sectors in Europe, but also export subsidies that enable producers to get rid of unwanted surplus.

[44] See Kenen (1994), Evans and Walsh (1996), and Ethier (1995).

[45] See WTO (1996).

[46] In February 1997, a framework agreement, under the auspices of the WTO, was reached on the opening of domestic and international telecommunication markets to competition and foreign investment. Already, in 1998, progress towards liberalisation will be made in major portions of the world market, including the United States, EU and Japan. By 2005, these measures will be taken by another group of countries. Discussions for an agreement opening domestic markets in banking, insurance and other financial services are also well underway, see *Economist* (several issues).

[47] See Evans and Walsh (1996) for comprehensive coverage of the agreements.

change in attitudes regarding the relative benefits of regionalism *vis-à-vis* multilateralism has been a remarkable feature of recent United States trade policy. Having been a strong supporter of the GATT multilateral approach, the United States turned to regionalism as a new way of accomplishing freer international trade. The reasons behind such a turnaround have been associated with an overall change in US perception regarding its position within the international arena. Bhagwati (1993b) argues that the recent loss of economic supremacy in the face of competition from Western Europe and East Asia led to an assumption in the United States that foreign firms benefit from 'unfair' advantages, sponsored by governments abroad. In their home markets, other countries would have the help of restrictive business practices to shelter them from import competition. And when selling abroad, they would benefit from subsidies and tax breaks. This perception led to a strong outcry for the United States to use protectionism to open foreign markets and curb 'unfair' practices. The move towards regionalism could then be understood as an element of this new approach to trade liberalisation. By acquiring closer reciprocal links with specific groups of partners, the United States could, in principle, guarantee 'level playing-fields' both at home and within foreign markets.

The surge of regionalism may also rest on a self-sustaining circle. Baldwin (1993) proposed an explanation for the spread of regionalism that rested on what the author called the 'domino' effect. Either the deepening or formation of a regional scheme, possibly for political reasons, would spark fears among exporters, from non-participant countries, of growing discrimination and falling sales and profits. Threatened by potential losses, exporters start lobbying for their country's accession. Ruling out resistance to new entrants within the existing bloc, the process of accession would depend on the relative power of domestic groups supporting or opposing integration. Thus, a picture can be envisaged in which renewed pressure from exporters will tilt the balance of incentives inside a country, leading to its accession. The increasing size of the bloc, moreover, leads to similar behaviour in other countries, where the balance of forces may not have previously backed accession. In sum, the continual widening of the integrated market will make the cost of being outside greater, tilt the balance of forces towards integration, and prompt more countries to accede.

The proliferation of RTAs sparked a heated debate over the consequences of such schemes for the achievement of free trade worldwide. The core of the controversy can be summarised in the following question: Does new regionalism hinder or enhance the scope for future trade liberalisation worldwide? The case in favour of regionalism can be put as follows:[48] given the problems facing the GATT negotiations for the effective liberalisation of such sectors as non-tariff barriers, foreign investment, and trade in services and agriculture, regional trade arrangements may be a smoother track to liberalisation. Multilateral negotiations were said to be a fertile ground for 'free riding', meaning that some countries benefit from non-discriminatory tariff reduction but refrain from offering similar concessions.[49] The reduced number of countries and interests involved in

[48] See Dornbusch (1993) and Lawrence (1996).

[49] Due to their differential treatment under several GATT rules, developing countries were often

regional negotiations would make coordination and enforcement easier, which would narrow the scope for free riding and facilitate a compromise. RTAs may also provide a 'learning' stage, in which nations experience the benefits of eliminating long-standing trade obstacles. This could indeed buttress the efforts to extend trade negotiations and concessions to a wider circle of countries. For example, a trade-creating RTA may increase the size of the export sector and reduce the size of the import-competing sector, thus reinforcing the political support for trade liberalisation. Therefore, the surge of regional integration may well lead to a 'higher plateau' of worldwide negotiations. Dornbusch summarised the argument as follows:

> In this optimistic perspective ten years of successful regional liberalisation may well be the prelude to a major round of world trade liberalisation of the kind that today seems difficult to reach.[50]

As with most controversial issues in economics, there is also a strong case against regionalism. Helleiner (1993) argued that by bypassing the non-discriminatory nature of GATT, regionalism posed a threat to the world trading system. A world divided by trading blocs, each with different a set of rules and principles, would mean a return to the 1930s and to its pitfalls: mounting protectionism, and growing political and economic rivalry. The point here is that the possibility for enjoying terms of trade gains, while imposing obstacles to trade with non-members, may be too tempting to be resisted. Thus, the formation of trading blocs may denote a surge of trade barriers and retaliation, with serious consequences for world welfare. Moreover, others attested that there was no guarantee that RTAs would evolve towards a multilateral framework. Regional arrangements may even hinder multilateral negotiations. Negotiations at a regional level may divert political and diplomatic resources from multilateral talks. Kenen (1994) recalled that this was the case when, during the 1980s, the EU perceived the Uruguay Round as a 'troublesome distraction' from the effort to complete the Single European Market. Bhagwati (1993a) stressed that, after securing large regional markets, governments' interest in multilateral talks may be weakened. Moreover, private interests trying to avoid growing competition may hinder further expansion of regional arrangements. He also stressed that regionalism need not be either faster or more efficient than multilateralism. For example, it was noted that the achievements of the EU have been carved out of decades of negotiations.[51] Regarding the efficiency of new regional schemes, Bhagwati pointed out that small economies might accept less than optimal terms when bargaining their entry into regional schemes dominated by a large member.

By the mid-1990s, it seemed the debate regarding the role of regionalism in the world trading system had become less controversial. On the one hand, empirical evidence has not given support to the view of a world trade system

charged with free riding in former GATT negotiations; see Krueger (1995).

[50] Dornbusch (1993), p. 193.

[51] In this respect, it will be interesting to compare the process of implementation of both WTO and NAFTA provisions in the coming years.

increasingly dominated by trading blocs.[52] On the other hand, the multitude of recent preferential agreements among GATT members did not block a successful outcome from the Uruguay Round.[53] Indeed, in a recent WTO report, regional schemes were portrayed as having a complementary role in fostering trade liberalisation.[54] In this respect, the call for 'open regionalism' has been intensified. Nogues and Quintanilla (1993), for example, outlined six broad characteristics that such an outward-looking regional arrangement should attain. Firstly, liberalisation of intra-regional trade should be overwhelming; tariff and non-tariff barriers should be dismantled and a strict limit should be imposed on interim exceptions. Secondly, trade with outside partners should also be liberalised. In the case of customs unions, CETs should be lower than the average tariffs before the union. For free trade areas, rule of origin should not aim at providing further protection against sources outside the arrangement by being too restrictive. Next, regional schemes should have a universal inclusion clause allowing any country to accede. Fourth, the agreements should include a clause that hinders the adoption of anti-dumping and countervailing measures. Fifth, member countries of a free trade area should be open to unilateral liberalisation attempts, or continuing regional unilateral liberalisation should be pursued in case the existing common external tariffs are relatively high. Finally, regional trade arrangements should show a commitment to multilateral trading negotiations.

The New Regionalism and Latin America

As emphasised above, the new surge of regionalism has encompassed new schemes not only between developing countries, but between these and developed countries. It has also been noted that many new arrangements and attempts to revitalise old schemes have taken place in Latin America. In this section, I will turn to motives and the challenges facing the new surge of integration in the region. As noted in the introduction to this paper, the adoption of a more outward-oriented development strategy revealed a significant process of unilateral trade liberalisation in Latin America, and it is in this context that the resumption of regional integration can be viewed. Given that protection has been unilaterally reduced, the new surge of regional integration may be somewhat perplexing. Low trade barriers mean that the (static) gains associated with liberalisation have to a large part already been attained and the 'carrot' for regional schemes is long gone. The proliferation of regional agreements conceals, however, peculiar motivations that need close investigation.

The 1960s' impetus towards integration was directly linked to the import-substituting industrialisation (ISI) model. As mentioned earlier, the cost of ISI

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52 See Srinivisan, Whalley and Wooton (1993).

53 As Peter D. Sutherland, GATT director-general in 1994, stated: ' as of the beginning of 1994, almost all of GATT's (then) 115 contracting parties were members of at least one preferential trade agreement, with the preferred vehicle being free trade areas – they outnumber customs unions five-to-one'. Sutherland (1994), p. 2.

54 This is not to say that the debate has been settled, since there are doubts if RTAs would, in practice, comply with commitments to further liberalisation. See WTO (1996) for an evaluation of the complementary role of regionalism and Bhagwati (1997) for a critique.

began to increase rapidly when countries started to promote manufacturing industries where economies of scale prevailed and the cost of operating sub-optimal plants was great. In many cases, constrained by their relatively small market, individual countries were not able to provide an optimum scale of production to reap the benefits of lower average cost. Therefore, regional integration was conceived as a way of rationalising ISI. A regionally integrated market would provide the basis for a more efficient industry and reduce the cost of stepping up the industrialisation process.[55]

In the case of LAFTA, the scheme was initially composed of nine members: Argentina, Brazil, Chile, Colombia, Ecuador, Mexico, Paraguay, Peru and Uruguay. Bolivia and Venezuela acceded in 1966 and 1967 respectively. In order to achieve regional trade liberalisation, national and common tariff concessions were established. The former referred to voluntary concessions and the latter referred to general reductions in tariffs to an agreed list of products. Within both schemes, tariffs were to be eliminated gradually on a product-by-product basis. Furthermore, agreements for industrial complementation were proposed to boost trade in sectors with low inter-regional trade. Negotiations within LAFTA soon began to face serious problems. The initial rise in trade was concentrated in the most developed countries and tariff concessions were far from reaching more relevant proportions of regional trade. Most importantly, the attainment of further reductions in barriers to trade began to meet with great resistance from various quarters. The less developed countries demanded more preferential markets for their exports and a more active regional industrial policy. In turn, import-competing producers in more industrialised nations viewed the deepening of integration with caution, as it would introduce an unwelcome degree of competition within their domestic markets. Consequently, by 1969, there was a generalised postponement of most deadlines for liberalisation. In 1980, LAFTA was replaced by LAIA in an attempt to renew discussions on regional integration. In particular, LAIA incorporated a formal mechanism for bilateral trade agreements, which limited tariff concessions to countries involved in such agreements.

As a reaction to the problems confronted in LAFTA, in 1969 the Andean Pact was formed between Bolivia, Chile, Colombia, Ecuador and Peru (Venezuela joined in 1973). Apart from trade liberalisation, the aims of the scheme were largely associated with the establishment of a regional industrial policy, which could coordinate investment and trade in manufactured goods. Trade liberalisation was envisaged via an automatic reduction in tariffs and the introduction of a CET, which would be completed by 1980, in the case of Chile, Colombia, Peru and Venezuela. Bolivia and Ecuador were given preferential treatment and had until 1990 to phase out their tariffs. Regional investment programmes were designed to foster industrialisation in regional markets, and a common code of treatment for foreign direct investment was also to be set out. The initial expansion in inter-regional trade was important, with the proportion of total exports going to regional markets increasing from 1.7 per cent in 1970 to

[55] See Nogues and Quintanilla (1993), and Edwards and Savastano (1989).

4.5 per cent in 1979.[56] Nevertheless, deep internal divisions emerged regarding the extent of trade liberalisation and scope of investment policies. Exceptions to tariff reductions proliferated and deadlines for the implementation of a CET were postponed. Furthermore, the investment programmes were not fulfilled, and disputes over a common treatment for foreign investment led to Chile's withdrawal in 1976.

Judging by the extent of trade liberalisation and expansion of intra-regional trade, the CACM could be considered the most successful regional scheme in Latin America during the 1960s and 1970s. The scheme was formed by Costa Rica, El Salvador, Guatemala, Honduras, and Nicaragua in 1960. By 1966, tariffs were eliminated, a CET was achieved for 94 per cent of goods, and the proportion of total exports going to regional markets increased from 7.5 per cent in 1960 to 24.2 per cent in 1968.[57] The dynamism of integration was nevertheless seriously marred by problems regarding the distribution of benefits among the member countries. In the 1980s, political turmoil and adverse external shocks led to the stagnation of the scheme.[58] Lastly, one should mention efforts towards regional integration in the Caribbean, which started in the mid-1960s when Antigua, Barbados and Guyana formed the Caribbean Free Trade Association (CARIFTA). By 1971, all Caribbean nations were associated to CARIFTA, which sponsored a fast reduction of trade barriers and an initial expansion of intra-regional trade. In 1973, the objectives of integration were intensified with the establishment of CARICOM, which aimed to adopt a CET, harmonise macroeconomic policies and create regional development agencies. The expansion of regional trade was, however, hindered by the intense reverberations from the oil shocks, sparking protectionist measures in many member countries. By the mid-1970s, the share of total exports going to regional markets returned to levels seen in the late 1960s.

Reasons for the failure of regional integration usually revolved around two major factors.[59] Firstly, the protectionist climate of that time meant countries might wish to expand their exports, but few would genuinely conceive of opening up their domestic markets. Secondly, given that those barriers to non-member countries were usually kept high, regional schemes tended to entail potentially high trade diversion. Trade in manufacturing would be diverted from producers in the rest of the world towards the more advanced countries, which often had a relatively more sophisticated industrial sector. As a result, the schemes were marked by conflicts between the low and high-income countries over the distribution of costs and benefits. Either the lack of appropriate compensation instruments generated discontent among relatively poor members, or the complexity involved in their implementation led to other distortions – innumerable tariff schedules and exceptions.

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56 See Edwards and Savastano (1989), p. 199.

57 See Edwards and Savastano (1989), p. 196.

58 See Cline (1982).

59 See Melo and Panagariya (1992), Melo, Panagariya and Rodrik (1993) and Langhammer (1992).

The motivations behind the recent surge of integration are markedly different to past experience. Two issues could be highlighted here. Firstly, regional integration is now seen as a vehicle in support of the 'new' economic model. By promoting regional trade liberalisation, Latin American countries aim to buttress the outward-looking development path.[60] In this context, the principles of open regionalism – which embodies, among other elements, low barriers to non-participants and more effective intra-regional trade liberalisation efforts – have been followed. In this respect, the countries are not only increasingly aiming to reap the standard benefits from freer regional trade, but are also securing gains from rationalisation of scale in manufacturing activities, fostering competition in oligopolistic sectors and encouraging direct foreign investment.

Regional integration is also a reaction to the prospect of increasing world fragmentation and discrimination. The threat of a world divided into areas of influence, with high barriers towards non-participants, could greatly undermine the current outward-orientation. Securing unfettered access to a large market would thus be a prominent issue. However, given that regional markets are limited in size, countries should seek broader trade arrangements, and the prospect of a free trade agreement under US auspices is then the most probable outcome. As noted before, in 1990 the United States government launched the Enterprise for the Americas Initiative (EIA), which unveiled, among other things, a framework for future trade negotiations with Latin American countries.[61] In this context, the objective of negotiating regional schemes in Latin America could be seen as a way of countetbalancing the strong negotiating position of the United States *vis-à-vis* its partners in the region. Here, two aspects are of particular relevance. The first relates to the prospect of a 'hub and spoke' pattern of trade and investment. By signing free trade area agreements with individual countries (spokes), the United States (hub) would obtain preferences in all markets. In turn, individual countries would obtain preferences only in the United States market. This would generate incentives for the diversion of investment towards the hub, where it would be possible to freely access all regional markets. This situation could be avoided by the establishment of RTAs among the spokes. The second aspect directly concerns the prospect of a hemispheric free trade agreement. By negotiating as a bloc the accession to a North American-based free trade zone, Latin American countries expect to minimise the asymmetry in bargaining power.[62] In the words of Rosenthal (1992):

> Whether it be for a world with transparent trade or a fragmented world, Latin American countries will fare better if they are integrated, if for no other reason than diversifying the risks of joining the world, or forming part of a larger bloc, such as a free zone in the hemisphere.[63]

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60 See IRELA (1992), Fuentes (1994) and Bulmer-Thomas (1997) for an overview on the new surge towards regionalism in Latin America, its motivations and obstacles.

61 See Whalley (1992).

62 There are, however, serious doubts whether, given the difference in economic size between Latin America and the United States, meaningful gains from improving bargaining power are really feasible.

63 Rosenthal (1992), p.80.

The motivations behind the signing of NAFTA and the prospect of an integration arrangement between the United States, Canada and other Latin American countries merit closer investigation. Melo and Panagariya (1992) elucidated some of the elements underpinning the regional arrangements between developing and developed countries. They argued that, within a context in which developing countries are undergoing reforms aiming at more liberal trade and investment regimes, such schemes may provide what is known as a 'lock in' effect. In essence, the binding commitments of the agreements would help to cement hard-fought policy changes. As previously noted, market access has been a major issue underlying such agreements. Bearing in mind the perils of the new protectionism, developing countries see such arrangements as a way of securing access to large markets for their exports. As one might envisage, the two aforementioned aspects interact. Since the potential 'penalties' – in terms of market access for example – for breaking the agreement are probably high, the chances of 'locking in' liberal policies, under the aegis of regional commitments, are reinforced. Developing countries can, moreover, 'borrow' from developed countries institutions that are conducive to growth and stability. The enlargement of the EC provides a good illustration of some of these elements in action. The entry of Portugal, Spain, and Greece into the European Community helped those countries to consolidate trade policy reforms. Moreover, it has been argued that the move in Europe towards economic and monetary union serves the objective of binding the members' macroeconomic policy to the anti-inflationary credentials of the German Bundesbank.[64]

Nevertheless, many challenges lie ahead for regional arrangements between developed and developing countries. Langhammer (1992) highlighted the fact that the potentially high inter-industry trade and specialisation resulting from such RTAs would lead to high adjustment costs. Given that relative factor endowments differ significantly among developed and developing countries, the likely outcome will be the reallocation of factors of production between broad economic sectors. Such shifts in resource allocation may raise the cost of adjustment, as in the case of long periods of idle capacity and extensive retraining.[65] There is also concern over the fact that developing countries may adhere to protectionist practices adopted by the developed member. For example, there is no guarantee that Mexico will not, as a result of NAFTA, begin to adopt protectionist measures (such as anti-dumping procedures and countervailing taxes) similar to those applied by the United States upon non-member countries. Indeed, in attempting to 'alleviate' growing competitive pressure inside the region, countries may be stimulated to adopt anti-dumping measures against outsiders.[66] Even if the non-tariff barrier is not adopted across

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64 See Melo, Panagariya and Rodrik (1993).

65 When economies showing relatively similar factor endowments integrate, the most likely outcome is growing intra-industry trade and specialisation. The shifts in resource allocation are confined to narrowly defined sectors, and the cost of reallocation is bound to be lower than in the case of inter-industry changes. For example, adjustments within branches of manufacturing transport equipment may lead to the relocation of labour from the production of finished cars to truck parts. Such changes in the composition of output and the labour force are likely to require less retraining than, say, a shift from fishery production towards high-tech manufacturing.

66 See Bhagwati (1993b).

the free trade area, a complex set of rules of origin will be needed to ensure that the measure works. And this may interfere with the normal functioning of the free trade area. In the case of a customs union, all members should follow the rise in protection sponsored by one member. Here, given the CET, the union will collectively adopt the unilateral rise in trade barriers.[67] In particular, a situation of potentially high trade diversion might be envisaged if developing countries establish a free trade area with developed countries but maintain high tariff and non-tariff barriers for non-member competitors. It is also worth recalling that the relatively low bargaining power of developing countries when negotiating with large countries might lead to non-optimal outcomes. Such concern is particularly relevant when issues related to deeper integration are at stake – for example, the harmonisation of intellectual property rights or environmental standards. The possibility that the bargaining process may lead developing countries to accept institutional frameworks that do not best suit their needs should be kept in mind.[68]

The Case of MERCOSUL

Major attempts to revitalise cooperation and integration between Argentina and Brazil date from the mid-1980s.[69] A changing political context, marked by a return to democracy in both countries, had helped to lessen old rivalries and generated a fertile terrain for closer diplomatic relations. The creation of the Programme of Economic Integration and Cooperation (PICE) signed in 1986 was an important step towards a regional scheme. The objectives of this programme were outlined in numerous statements and 24 protocols were signed between 1985 and 1990. To increase overall trade, negotiations were initiated for a gradual exchange of preferences on a product-by-product basis. A select number of sectoral agreements were envisaged, relating to such areas as transport, energy, steel products, aeronautics, vehicles and spare parts. The restructuring of manufacturing activity in both countries was a major underlying concern in these protocols.

However, the core of the whole scheme was the protocol on capital goods. The PICE aimed to create a customs union within this sector. To this end, a list of capital goods with zero tariffs and non-tariff barriers was drawn up, and its progressive expansion to include a whole range of goods was also agreed. Two factors justified the special attention given to capital goods: firstly, the severe drop in investment resulting from the contraction of GDP after the debt crisis led to a sharp cut in demand for capital goods. Secondly, it was argued that the sector could provide substantial positive externalities through technological innovation. Given existing imbalances in the foreign accounts of both countries, the programme also highlighted the need for the maintenance of a dynamic equilibrium in bilateral trade flows. To this purpose, a compensation mechanism was introduced. This would speed up trade liberalisation within the country

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67 Winters (1993) gives the example of voluntary export restraints on Japanese video cassette recorders (VCRs), initiated by France and applied by the whole European Community.

68 See Bhagwati (1993b) and Rodrik (1995).

69 See Meirelles (1995), Lucangeli (1995) and Campos (1991).

showing a surplus, and provide credit for financing ongoing deficits. Between 1986 and 1989, the bilateral trade in capital goods increased more than one and a half times. The trade in goods included in the common list grew fourfold during the same period. By 1989, transactions negotiated within the common list accounted for around 60 per cent of total bilateral trade.[70] Despite growing trade, there was no sign of an overall upgrade or structural change in supply. In turn, many shortcomings hindered the progress of negotiations. Characterised by general defensive behaviour, these negotiations began to face growing opposition to the introduction of new products to the common list. Given the importance of public spending on capital goods, the lack of harmony in public procurement significantly curbed the benefits of the enlarged market. The implementation of the CET was marked by delays. Most importantly, macroeconomic instability, reflected in the sharp fluctuations of the exchange rates, placed crucial impediments on long-term investment and greatly aggravated conflicts on both sides.[71]

Government intervention was intended to play an important role at the onset of PICE.[72] Both states were major purchasers of capital goods and crucial players in many protocols. For example, with regard to aeronautical protocol, a joint venture was set up between two state-owned companies for building and commercialising new aircraft. Joint government investments in research and development were also set up in such areas as biotechnology and information technology. This type of regional integration changed swiftly after 1989. The growing strain on government finance further curtailed public investment and placed severe limits on the role of the state in the integration process. In turn, although bilateral trade was on the rise, the gradual liberalisation approach, based on the product-by-product negotiations, proved to be inadequate in overcoming protectionist pressures. Furthermore, changes in policy-making in both countries strengthened the role of the market, and led to a significant reduction in protection on a unilateral basis. Lastly, the growing trend towards regionalism in North America and Western Europe put pressure on both governments to accelerate the integration process.

These new circumstances prompted a significant push towards trade liberalisation. In 1989, the Bi-national Treaty was signed aimed at the establishment of a common market between Brazil and Argentina in 1999. Most importantly, there was a shift from product-by-product negotiations to a mechanism of general, linear and automatic tariff reductions. This latter change was aimed at diluting protectionist pressure and accelerating a downturn in bilateral tariffs. The formation of MERCOSUL was completed in 1991, when Argentina, Brazil, Paraguay and Uruguay signed the Asunción Treaty. Given the existing close trade and investment links between Paraguay, Uruguay and their larger neighbours, their accession to MERCOSUL was seen as a natural consequence of the ongoing process. In fact, since the mid-1970s, several bilateral agreements had already been established between Argentina, Brazil,

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70 See Campos (1991), p. 28, Table 3.

71 See Campos (1991).

72 See Meirelles (1995), Chapter 7.

Paraguay and Uruguay. The PEC (Programme of Commercial Expansion) signed between Brazil and Uruguay in 1976, established preferential treatment for a long list of products that was meant to increase over subsequent years. In 1975, Argentina and Uruguay signed the CAUCE (Argentinean-Uruguayan Convention of Economic Cooperation) aimed at trade liberalisation, technological upgrading in the agricultural sector and the harmonisation of policies within the meat market.[73] By 1989, Paraguay had also signed a bilateral trade agreement with Argentina.

The Asunción Treaty revealed an ambitious objective: the formation of a common market among the contracting parties in 1995. In order to foster trade liberalisation, a schedule for progressive tariff reduction was agreed. In January 1991, a preference of 40 per cent was granted across all tariff schedules for intra-MERCOSUL trade and a successive increase in preferences was decided.[74] The elimination of non-tariff barriers and other obstacles hindering free trade, the coordination of macroeconomic policies, the establishment of sectoral agreements, the harmonisation of national legislation where necessary, and the adoption of a CET were also among the instruments proposed for achieving the common market. A list of products to be excepted from the tariff reduction was put forward, but its scope would be narrowed down over a period of time. Paraguay and Uruguay were allowed a longer list of exception, and more gradual phasing-out schedules than the ones granted to Argentina and Brazil. The treaty also specified rules of origin for intra-regional imports during the period of transition to a CET, a safeguard clause and procedures for settlement of disputes. In addition, the participants were called upon to elaborate a common regional policy for dealing with unfair trade practices (dumping and subsidies) within non-member countries. A regional competition policy was later envisaged for dealing with predatory business practices within MERCOSUL.[75] Two major institutional bodies were created; the Common Market Council and the Common Market Group. The former was to coordinate the integration process and take the decisions towards establishing a common market. The latter would be responsible for executing and enforcing the decisions taken by the Council.

The motivations behind MERCOSUL revolved around two issues. Firstly, the concern with international competitiveness was a clear feature. MERCOSUL was intended to enhance the ability to compete in world markets;[76] so that it could be seen as part of the new outward-looking development strategy. Secondly, the scheme was conceived to respond to growing regionalism overseas. The Asunción Treaty expressed the willingness to coordinate positions within the international arena and welcomed applications from other members of LAIA. As Jaguaribe (1993) argued, the success of MERCOSUL could be the catalyst for regional integration in South America, a role reinforced by the need

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[73] See Laens, Lorenzo and Osimani (1993).

[74] A 7% preference would be added in each semester until July 1994. Then, an 11% reduction would complete the elimination of the tariff barriers – IBGE (1993).

[75] See Machado (1995b).

[76] See Pena (1992) and Jaguaribe (1993).

to coordinate the increasingly confusing and complex network of bilateral trade agreements, which have erupted throughout the region since the mid-1980s.[77]

After four years of negotiations, MERCOSUL reached an 'imperfect' customs union. Free intra-regional trade in goods was accomplished, with some exceptions included in the so-called 'adjustment lists'. These lists accounted for approximately 20 per cent of all product lines and were to be phased out by 1999 in Brazil and Argentina and by the year 2000 in Uruguay and Paraguay.[78] The CET was agreed for 85 per cent of all products, with countries retaining national tariffs for the remaining 15 per cent. The CET ranged between 0 per cent and 20 per cent, with an average of 12 per cent. Three different levels of protection were distinguished, with lower tariffs for intermediate goods and higher ones for capital and consumer goods. Exceptions to the CET were divided into two groups. One referred to the national exception lists, which were to be phased out by the year 2001 for Brazil and Argentina and 2006 for Uruguay and Paraguay.[79] The second comprised a number of capital goods, telecommunications equipment, and computers and computer-related goods. Exceptions for capital goods would be eliminated in 2001 and for the other goods in 2006. Many non-trade barriers were eliminated in December 1994 during the Ouro Preto Conference, and procedures for the harmonisation and elimination of ongoing restrictions were devised.[80] Compared to past regional schemes, the degree of trade liberalisation achieved was considerable. With reference to LAFTA, Cline (1982) reported that 'only one-tenth of the total possible tariff categories were liberalised over nearly two decades'.[81] Moreover, the CET entailed considerably lower average tariff levels and dispersion than the ones prevailing before the integration process.[82]

Important steps were also taken for the coordination of international negotiations and the widening of trade preferences. Under the auspices of the Enterprise for the Americas Initiative, MERCOSUL countries and the USA signed a framework agreement outlining areas of mutual interest for future negotiations. In 1996, MERCOSUL and the European Union signed an agreement covering many issues, including the promotion of trade relations.[83] There has also been a widening of trade preferences towards other countries in the region. In 1996, Bolivia and Chile received the status of associate members and signed a free trade area agreement with MERCOSUL.[84] Moreover, talks have been held aimed at initiating negotiations to establish a free trade area encompassing all the countries in South America.[85] These movements have

77 See Rosenthal (1992).

78 Uruguay asked for 1018 positions to be included in the adjustment list, Argentina for 221, Brazil for 29 and Paraguay for 427. See Machado (1995a), p. 19.

79 The distribution of the list of exceptions was as follows: Brazil asked for exceptions in 233 tariff positions, Argentina in 232, Uruguay in 212 and Paraguay in 253. Exceptions refer to tariff levels above and also below the established CET. See Machado (1995a), p. 19.

80 *Gazeta Mercantil* (1995).

81 See Cline (1982), p. 216.

82 See Machado (1991).

83 See IRELA (1997).

84 See Machado (1996) and *Financial Times* (several issues).

85 See Barbosa (1995).

strengthened MERCOSUL's image as the catalyst for broader regional trade liberalisation.

However, many obstacles to integration still lie ahead, most notably the lack of coordination on macroeconomic policy. By setting out rules and agreements concerning the management of policy instruments, the governments are seeking to make the behaviour of regional macroeconomic variables less volatile, thus forging a better environment for investment decisions. The process of integration within MERCOSUL has been pursued despite grave macroeconomic instability both in Brazil and Argentina. Sharp fluctuations in exchange rates and in trade balances have accompanied the rise in trade flows. On many occasions, a surge in import demand has prompted calls for protectionism. In Argentina, between 1992 and 1993, quotas and anti-dumping procedures were imposed on intra-regional imports. More recently, Brazilian authorities also attempted to extend trade barriers to intra-regional trade to curb soaring imports.[86] Although successful efforts at price stabilisation have been introduced in Argentina, and, more recently, in Brazil, both economies still face significant adjustment problems. Since short-term stabilisation should continue to be given priority on the policy agenda, the scope for macroeconomic coordination is limited. Both countries require a great deal of discretion over the choice of policy, which considerably hampers the pursuit of rules and mechanisms to underscore coordination. This conclusion suggests a prospect of volatility that may overshadow investment decisions.[87]

The CET was a major source of conflict. During negotiations, Brazil pushed for a considerably higher degree of protection than envisaged by the other members. The discrepancies were particularly marked for capital goods, telecommunications equipment, computers and computer-related goods. Such activities are considerably larger scale and more sophisticated in Brazil than in the other countries. There was, therefore, a strong commitment within the country to allow more time for adjustment *vis-à-vis* foreign competition. In contrast, Argentina had slashed tariffs to zero in those sectors expected to favour investment and much-needed technological upgrading. The controversy was resolved by the proposal of a new group of exceptions to the CET. Nevertheless, it was clear during negotiations that the two countries favoured different approaches to trade liberalisation. Whereas in Brazil concerns over the impact of liberalisation on some manufacturing sectors were vociferous, the Argentine position pointed to the benefits for its economy of reduced protection.[88] Bearing this in mind, future success in fully implementing the CET will prove a true commitment to long-lasting integration.

As noted above, the Treaty of Asunciốn envisaged the elimination of all obstacles that directly and indirectly hinder the free circulation of products. This comprised the harmonisation of technical norms and standards. However,

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86 See Kume (1996).

87 For a recent account of the problems confronting macroeconomic coordination within MERCOSUL, see Fernández and González (1996).

88 See Meirelles (1995), Chapter 7 and Machado (1994).

attempts in this area have encountered serious obstacles. Machado (1996) argued that the lack of appropriate legislation and institutions dealing with norms and standards, particularly in the smaller countries, has made the task much more difficult. Financial and technical resources are needed not only for harmonising aspects that may obstruct trade, but also for creating desirable, internationally recognised norms and standards where they are lacking. The implementation of a regional competition policy appears to be hampered by similar problems. Regulatory frameworks for curbing predatory behaviour are either non-existent or inadequate, meaning that much of the work has to start from scratch. Measures for facilitating customs procedures have also been delayed. Consequently, problems relating to discrepancies in national legislation, excessive bureaucracy and inadequate technical resources began to hinder intra-regional trade. Moreover, the lack of investment in infrastructure has resulted in a transport system that has been unable to cope efficiently with fast-growing trade.

There has been criticism of the institutional framework that encompasses the whole integration effort. It is argued that the inter-governmental bodies established by the Treaty of Asunción do not provide grounds for an effective mechanism of dispute settlement, nor are they strong enough to cope with the challenge of 'deeper' integration. Many of the disputes among member countries have so far been resolved by direct negotiations between governments. Indeed, the absence of complex and expensive regional institutions has, until now, been a much-appreciated feature of the integration process. However, critics claim that such methods for dealing with controversy rely excessively on the prevailing political environment and the willingness of government officials to negotiate.[89] Moreover, in view of the many problems incurred in attaining free intra-regional trade, there are doubts as to whether the existing institutional bodies will cope with the task in hand. In essence, the need for some sort of supra-national council, with more autonomy from the prevailing political establishment, has been often emphasised.[90] This permanent supra-national sphere should make the mechanisms for dispute settlement more transparent and facilitate the accomplishment of the successive stages of integration. Last, but not least, the establishment of a permanent MERCOSUL institution, capable of dealing with the issues highlighted above, will require extra financial and technical resources.

Analysis of Trade Flows in MERCOSUL

MERCOSUL was conceived as instrumental in buttressing efficiency and as a step towards an outward-looking development strategy. However, there is no *a priori* assumption that an imperfect customs union will ensure a move towards a better allocation of resources. Thus, it is paramount to gauge the impact of MERCOSUL on trade flows and welfare. Table 2 presents total trade flows and GDP per capita in each member country, over the last decade. After a decade of absolute decline in GDP per capita, the early 1990s brought a resumption of

[89] See Machado (1995b) and Machado (1996).
[90] See Araújo (1997).

growth in all countries. As GDP has grown, international trade has boomed. Nevertheless, the behaviour of exports and imports has been markedly different; in all countries, the recent growth of imports outpaced the expansion of exports. The differences in export and import growth rates have turned a considerable trade surplus at the start of the 1990s into a rising trade deficit by the middle of the decade. Many factors account for this performance: firstly, tariff and non-tariff barriers have been unilaterally slashed in all countries; secondly, although GDP growth has fluctuated significantly, Table 2 shows a recent upward trend in most countries; and thirdly, there have also been signs of exchange rates being increasingly overvalued.[91]

Table 2 - External Trade and GDP *per-capita* in MERCOSUL
Average Annual Growth Rates

GDP per capita (%)

	1980-90	1990-95
Argentina	-2.2	3.9
Brazil	-0.6	1.1
Paraguay	-0.2	0.3
Uruguay	-0.3	3.0

Average Annual Growth Rates
Exports (%)

	1980-90	1990-1995
Argentina	5.0	7.1
Brazil	7.1	6.3
Paraguay	8.1	12.5
Uruguay	4.7	6.7

Average Annual Growth Rates
Imports (%)

	1980-90	1990-1995
Argentina	-8.2	27.1
Brazil	-0.2	17.0
Paraguay	7.7	15.0
Uruguay	-1.0	14.7

Source: IDB (1996).

91 Although there is evidence suggesting considerable appreciation of real exchange rates in countries such as Argentina, the extent to which these shifts in real exchange rates are not consistent with balance of payments equilibrium in the long run is open to debate, see Edwards (1993).

Table 3 - MERCOSUL and ROW Imports and Exports
(US$ millions at current prices)

Argentina

	Average 1986-89 (1)	Average 1990-96 (2)	(2)/(1)
Exports to MERCOSUL	991.7	4014.0	4.05
Exports to ROW	6985.5	11910.2	1.70
Total	7977.2	15924.2	
Imports from MERCOSUL	968.5	3565.2	3.68
Imports from ROW	4043.2	12011.5	2.97
Total	5011.7	15576.7	

Brazil

	Average1986-89 (1)	Average1990-96 (2)	(2)/(1)
Exports to MERCOSUL	1392.0	4641.8	3.33
Exports to ROW	27376.2	34669.5	1.27
Total	28768.2	39311.4	
Imports from MERCOSUL	1398.0	4266.8	3.05
Imports from ROW	15656.2	27661.4	1.77
Total	17054.2	31928.2	

Paraguay

	Average 1986-89 (1)	Average 1990-96 (2)	(2)/(1)
Exports to MERCOSUL	200.9	397.9	1.98
Exports to ROW	340.5	438.8	1.29
Total	541.4	836.7	
Imports from MERCOSUL (*)	230.8	645.2	2.79
Imports from ROW (*)	320.3	1039.0	3.24
Total	551.2	1684.3	

Uruguay

	Average 1986-89 (1)_	Average 1990-96 (2)	(2)/(1)
Exports to MERCOSUL	394.2	790.7	2.01
Exports to ROW	922.8	1075.2	1.17
Total	1317.0	1866.0	
Imports from MERCOSUL	453.7	1053.2	2.32
Imports from ROW	642.7	1279.0	1.99
Total	1096.4	2332.2	

Source: Elaborated by the author with data from SALA (1996) and (*) Brazilian Central Bank: *MERCOSUL Bulletin* (various years).

Table 3 presents the performance of trade flows to and from MERCOSUL and the rest of the world (ROW) to each member country. Clearly, compared to the period 1986-89, the start of the 1990s saw an expansion in trade flows within regional and ROW markets. However, in all countries except Paraguay there has been a relative reorientation of imports and exports towards MERCOSUL. The shift has been greater for exports in Argentina and Brazil. Brazilian exports to MERCOSUL increased more than three times in the period, whereas exports to ROW rose by 27 per cent. Imports from MERCOSUL grew more than three times, while imports from ROW grew 77 per cent. In Argentina, regional exports rose more than fourfold in the period considered, while exports to ROW rose by only 70 per cent. Imports from MERCOSUL increased almost fourfold, while purchases from ROW grew almost threefold.[92]

Table 4 presents GDP shares of exports and imports during the 1989-90 and 1994-95 periods. Looking at exports, one can note that in all countries the share of extra-regional exports over GDP decreased in the period considered. The GDP share of intra-regional exports increased in Argentina, Brazil and Uruguay, but decreased in Paraguay. With regard to imports, one can see a rise in the ratio of intra-regional imports to GDP in all countries. Figures for extra-regional import shares also rose in all countries. In Argentina, Brazil and Uruguay, the rise in intra-regional shares was, however, considerably higher than the increase in extra-regional shares. Again, this evidence suggests a relative reorientation of trade towards MERCOSUL.

Table 4 - Trade-GDP Shares: 1988/89 and 1994/95 (%)
Exports/GDP

	1988/89		1994/95	
	MERCOSUL	ROW	MERCOSUL	ROW
Argentina	1.39	9.87	2.05	4.48
Brazil	0.42	8.79	0.94	6.09
Paraguay	6.73	12.58	5.66	4.66
Uruguay	5.53	13.63	5.57	6.27

Imports/GDP

	1988/89		1994/95	
	MERCOSUL	ROW	MERCOSUL	ROW
Argentina	1.23	4.50	1.65	5.74
Brazil	0.48	4.52	0.89	5.57
Paraguay	5.78	8.69	12.25	17.00
Uruguay	6.54	8.67	7.92	8.72

Source: Brazilian Central Bank: *MERCOSUL Bulletin* (various years).

92 Recent trade figures for Argentina and Brazil have shown similar features. Between 1996 and 1997, Brazilian exports to MERCOSUL rose 23.8%, while exports to ROW increased barely 9%. For imports, purchases from MERCOSUL rose 16.42%, whereas purchases from ROW increased by 14.86%. In the case of Argentina, between 1996 and 1997, exports to MERCOSUL countries rose 13.98%, in clear contrast to the flow towards the ROW, which increased only 1.92%. Imports from MERCOSUL rose by 30.97%, whereas purchases from ROW increased 26.53%. See SECEX (1998) and INDEC (1998).

The evolution of trade shares over time does not provide information on the magnitude of trade creation and trade diversion. In addition to regional trade preferences, those shares are influenced by unilateral changes in protection within MERCOSUL and the ROW, the modification of consumer preferences, changes in comparative advantage and differences in GDP growth rates between regional and ROW markets. Therefore, to shed light on the net benefits of integration, one needs a much more careful examination of trade flows.

Yeats (1996) took a step in this direction by using export data to build several indices to evaluate the relative importance of trade diversion and trade creation. Firstly, the study showed the rise in intra-MERCOSUL shares over total exports for the period 1979-81 and for 1994. It also revealed that manufactured goods accounted for an increasing proportion of intra-MERCOSUL exports. To give an idea of the relative importance of regional and world markets for each country's exports, a trade-intensity ratio was constructed. This gives the ratio of two relative variables: the first is the share of intra-regional exports of country *I* to *J* over total *I* exports and the second is the share of country *J* total imports over the world total imports net of country *I* imports. For MERCOSUL, the figures showed a considerable rise, particularly after the late 1980s, meaning that there has been a reorientation of trade towards regional markets, even when one takes into account the changes in the size of regional markets. To examine the net welfare effect of the shift in trade flows, three additional indices were compared. First, a regional orientation index was built for commodity *J*, indicating the relative importance of intra-regional over ROW markets for its exports. In addition, an index of revealed comparative advantage was constructed, which examines the MERCOSUL's propensity to export commodity *J* in relation to the rest of the world. Finally, an index of factor intensity was used, delineating the relative labour-intensity of commodity *J* production. By comparing orientation and revealed comparative advantage indices, it is clear that the commodities showing the greatest reorientation (largest positive change of orientation index) towards MERCOSUL markets were the ones with a strong comparative disadvantage. Moreover, commodities with a fast growing orientation index were also found to have wide margins of preference for intra-regional sales. In sum, MERCOSUL's preferences had created perverse specialisation; they spurred trade in commodities in which countries had comparative disadvantage. This evidence led the author to suggest that MERCOSUL was predominantly diverting trade and thus harmful to the region and to the world as a whole.

Although Yeats's analysis was considerably more complex than the simple observation of trade shares, it still relied on indices that may or may not capture the intended effects. Indeed, if import data is used instead of export data, much of the above would no longer be valid. Devlin (1996) analysed import values for 1990 and 1995 and found the reorientation effect to be much weaker than in the case of exports. Furthermore, there was no strong correlation between the level of MERCOSUL preferences and the change of trade orientation.

Cristaldo (1994) also attempted to evaluate the magnitude of trade diversion and trade creation within MERCOSUL. The study referred to data for 1989 and could thus be seen as an *ex-ante* attempt to measure the impact of MERCOSUL. The author relied on a partial equilibrium model, whereby the magnitude of trade creation and diversion depends on: the price-elasticity of import demand; the elasticity of substitution between regional and ROW imports; the differences in regional and ROW export prices; the share of ROW imports in total imports; and changes in the tariff levels. The main assumptions of the model included an infinite elasticity of export supply, similar price and substitution elasticity for every country in the region and fixed world prices. Before integration, it was assumed that intra-MERCOSUL and ROW imports would be subject to similar tariffs. The establishment of MERCOSUL would imply free trade among members and a CET. Table 5 presents the main results of Cristaldo's analysis. The figures refer to a CET that is equal to the average tariff prior to integration. They also refer to two levels of elasticity of substitution between MERCOSUL and ROW imports and two ratios of ROW and MERCOSUL export prices. The first two columns account for the net welfare benefit from integration as a proportion of GNP, given that export prices are similar in MERCOSUL and ROW (p* =1). The last two columns indicate the results for the situation in which ROW prices are half those in MERCOSUL (p* =0.5).[93]

Table 5 - *Ex-ante* MERCOSUL Net Benefit (% of GNP)

	P*=1		**P*=0.5**	
	High	low	high	low
Argentina	0.004	0.003	-0.3	0.0
Brazil	0.01	0.01	-0.1	0.2
Paraguay	-0.12	-0.16	-3.2	1.7
Uruguay	0.09	0.09	-2.8	0.2

Source: Cristaldo (1994), p. 106, Table 6.2, and p. 109, Table 6.3.
high scenario – elasticity of substitution equals 2.5
low scenario – elasticity of substitution equals 1.5

According to Table 5, Brazil was the country most likely to gain from integration. Only when elasticity reaches high levels and relative prices are 0.5, would Brazil lose out. At the other extreme, Paraguay would seem to lose in almost all scenarios but one: when relative prices and elasticity were low. In fact, in the first two columns Paraguay demonstrated negative trade creation; goods imported before integration were now supplied by domestic firms. The figures for Uruguay followed a similar pattern to those for Brazil. However, Uruguay would lose out considerably in case of high elasticity and low relative ROW-MERCOSUL prices. Argentina would gain when relative prices are equal and lose otherwise. The relatively favourable picture for Brazil and gloomy scenario for Paraguay is a function of the impact of a CET. In Brazil, the CET was substantially lower than the tariffs prior to integration; thus, MERCOSUL

93 When price differences between MERCOSUL and ROW are absent, the possibility of trade diversion disappears and net welfare benefit improves.

meant an overall opening up to international markets. In the case of Paraguay, the opposite occurred: the implementation of the CET raised the level of protection with a negative effect on welfare.

Some important shortcomings could be highlighted in Cristaldo's methodology. Firstly, it would be useful to consider a more realistic approach to the export sector, namely a less than infinite elasticity of export supply. Secondly, by ruling out general equilibrium effects, one significantly restricts the impact of trade liberalisation and its effect on distinct sectors. Integration will lead to changes in factor prices, real exchange rates, income and inter-sectoral relations. These changes cannot be foreseen within a partial equilibrium framework. Thirdly, relative ROW-MERCOSUL prices do vary between different sectors and the two scenarios describe only two hypothetical outcomes. However, the study yielded some important results. The benefits of MERCOSUL may be spread fairly unevenly over the four members. And, to ensure welfare gains and restrict the scope for losses that might considerably affect the smaller countries, MERCOSUL should aim at a low CET.

Conclusions

From the mid-1980s onwards, the world economy has witnessed a revival of regionalism. Compared to the surge of RTAs back in the 1960s, this new trend has quite distinct characteristics. Not only has there been a clear reduction in tariff and non-tariff barriers, but also a great deal of effort towards reducing 'non-border' obstacles to trade and harmonising policies and standards. The measures taken to facilitate the flow of direct foreign investment are of particular importance. The main motivations behind the new regionalism stemmed from the problems regarding multilateral negotiations. Notwithstanding the successful end of the Uruguay Round of GATT negotiations, there are still uncertainties over the implementation of the agreed procedures and the prospects for future agreement on key issues such as intellectual property, services and foreign direct investment.

One remarkable feature of new regionalism has been the United States's adherence to its tenets. Previously a strong supporter of multilateralism, the United States has sponsored NAFTA and has now turned its sights to other parts of Latin America for further trade arrangements. Here, like Baldwin's domino effect, the continual widening of the EU has certainly influenced the United States's change in attitudes. Difficult questions arise when one considers the effects of regionalism on the achievement of free trade worldwide. Both sides of the debate have convincing arguments and weaknesses; there are no easy answers. In practical terms, there are calls to ensure, possibly through a WTO ruling, that new and existing regional schemes are conducive to further trade liberalisation and limited in their capacity to harm outside competitors.

The establishment of new RTAs between developing and developed countries, as in the case of Mexico and NAFTA, or the widening of existing schemes to encompass relatively poor countries, as in the EU, have been other key features of the new process of integration. Guaranteed access to a large market, the opportunity to 'lock in' reforms to trade and investment regimes and the possibility to 'borrow' institutions conducive to growth and stabilisation are major incentives for developing countries. There are, however, important shortcomings. Developing countries may end up adopting the protectionist habits of rich partners, to their own detriment and that of the world as a whole. Moreover, when it comes to the harmonisation of policies and standards, the bargaining process may lead to unfavourable procedures or legislation for countries with a lower level of development.

Latin America has been the scenario for many renewed attempts at integration, which are now being perceived as an element of a new development strategy. The new model for development again relies upon international trade as the 'engine of growth', and boasts an impressive process of unilateral trade liberalisation. Thus, regionalism has taken on the instrumental role of buttressing international trade. Another characteristic of the new regionalism in Latin America relates to the bargaining of a prospective trade agreement with the United States. RTAs would avoid the so-called 'hub and spoke' pattern of trade and investment. Here, distorted incentives would be likely to encourage investment in the economy with the largest market and with free access to all the countries. In addition, the formation of a regional scheme appeals to many, as being the best approach for counterbalancing the asymmetry in bargaining power when negotiating an RTA with the United States.

Bearing in mind these changes in course in Latin America, this paper has examined the achievements and pitfalls of MERCOSUL. At the start of the 1980s, Argentina and Brazil began a process of diplomatic and commercial approximation that culminated in the 1986 PICE. Integration evolved around several protocols concerning sectoral agreements and proposals for gradual product-by-product trade liberalisation. The most important part of the programme was the liberalisation of trade in capital goods. Following a period of successful trade expansion, negotiations stagnated as they were blocked by protectionist pressures. Moreover, growing strains on government finance limited achievements in other areas where the state had a prominent role. Increasing macroeconomic volatility also considerably curbed the impetus for investment and changes on the supply side. Changes in domestic and external circumstances hastened the integration process. Across-the-board tariff reductions were introduced, and both countries began to envisage the formation of a common market. Having already established close trade and investment links with Argentina and Brazil, Uruguay and Paraguay were incorporated in the scheme. In 1991, the Treaty of Asunción created MERCOSUL and anticipated the establishment of a common market by 1995. The agreement covered the dismantling of tariff and non-tariff barriers and the elimination of all measures that hinder the circulation of goods and services. The harmonisation of norms, standards and policies was also put high on the agenda.

After the four years of transition, MERCOSUL reached an imperfect customs union. Around 80 per cent of all commodities were given duty-free treatment within MERCOSUL. A CET was agreed upon for 85 per cent of tariff lines. The scope for liberalisation has been substantial when compared with the poor results of previous attempts in the region. More importantly, the implementation of the CET has reduced both the average tariff and the variance between tariffs when compared to levels prior to integration. The efforts to harmonise norms and standards, and to eliminate and simplify customs procedures, have come up against serious obstacles. Delays in these areas have hindered the rising flow of trade. Given the short-term problems associated with macroeconomic imbalances, the scope for coordinating exchange rates, monetary and fiscal policies seems limited. Thus, the already recurrent conflicts between the objectives of trade liberalisation and the need to accomplish short-term equilibrium in the macroeconomic sphere are likely to persist.

By looking at data on recent trade flows and examining some studies on the theme, an attempt has been made to analyse the potential net welfare benefits of MERCOSUL. Apart from the usual caveats linked to each method of measurement, the task of evaluating the benefits in MERCOSUL has been further complicated by a number of other factors. In most studies, it is not possible to separate the impact of MERCOSUL preferences from the effects of rising growth rates, unilateral cuts in tariffs and possibly overvalued exchange rates. These elements are, however, crucial in explaining the rise in total trade and, most important, the rapid expansion of imports between the late 1980s and early 1990s. By looking at the trade figures for intra-MERCOSUL trade and trade with the ROW, one can note a relative reorientation of trade towards MERCOSUL. The changes have been greater in the larger countries and on the export side. A similar picture emerged when the shares of intra-MERCOSUL and ROW imports and exports over GDP were evaluated. These measures were, nevertheless, affected by many elements apart from regional preferences, and they did not serve the purpose of measuring trade diversion and trade creation. Attempts have been made in this direction. Yeats (1996) devised a series of indices based on export data, concluding that MERCOSUL was to a large extent responsible for widespread trade diversion. However, looking at similar indices based on imports, Devlin (1996) did not find evidence of significant trade diversion. Adopting a partial equilibrium model, Cristaldo (1994) provided *ex-ante* estimations of the effects of MERCOSUL on welfare. The conclusions were sensitive to the values of key parameters and to distinct scenarios referring to relative export prices. Within her hypothetical scenario, changes in protection against ROW, resulting from the implementation of the CET, mainly determined gains from integration. Cristaldo identified one big winner, Brazil, which would experience an overall reduction in tariffs. She also identified a potential big loser, Paraguay, where integration would raise barriers to trade.

These mixed results suggest that further research is needed to enable any real conclusions on the issue. However, some factors can be highlighted that would enhance trade creation and curb diversion. The deadlines for interim exceptions should be fulfilled, and members should seek the widening of preferences for other countries. The use of anti-dumping procedures and countervailing measures towards extra-regional imports needs to be restricted. Finally, MERCOSUL should implement measures to simplify customs procedures and harmonise norms and standards, which clearly hinder the circulation of products within the region. In addition, there is a case for close monitoring of trade flows and tackling emerging distortions. Lastly, there are important concerns about the institutional structure of MERCOSUL. To secure what has already been achieved and facilitate future stages of integration, it is argued that some degree of discretion over domestic policies should be sacrificed to accomplish the goals of integration. Thus, the gradual building of supra-national entities and legislation should be considered. These institutional changes should strengthen the dispute settlement mechanism, making it more transparent and open to complaints, reduce the reliance on prevailing political circumstances and step up the harmonisation of standards and other policies.

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CONTRIBUTORS: *Luis Abugattás, Elena Alvarez, Javier de Belaúnde, John Crabtree, Carlos Iván Degregori, Francisco Durand, Adolfo Figueroa, Raúl Hopkins, Javier Iguíñiz, Drago Kisic, Enrique Obando, Martin Tanaka, Jim Thomas, Rosemary Thorp.*

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CONTRIBUTORS: *Marta Altolaguirre*, Marta Elena Casaús*, Demetrio Cojtí*, Edgar Gutiérrez*, Frank La Rue, Roger Plant, Gustavo Porras*, Alfonso Portillo*, Jennifer Schirmer, Rachel Sieder, David Stoll, Rosalina Tuyuc*, Anna Vinegrad, Richard Wilson (* Chapters in Spanish).*

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CONTRIBUTORS: *Kathleen Bruhn, Rogelio Hernández Rodríguez, Alonso Lujambio, Antonia Martínez Rodríguez, Paola Martorelli, James A. McCann, Yemile Mizrahi, Juan Molinar Horcasitas, Alejandro Moreno, Jean-François Prud'home, Mónica Serrano, Mony de Swaan, Laurence Whitehead.*

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CONTRIBUTORS: *Daniel Balderston, Malcolm Bowie, Evelyn Fishburn, Gabriel Josipovici, Bernard McGuirk, Sylvia Molloy, Eduardo L. Ortiz, William Rowe, Jason Wilson.*

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CONTRIBUTORS: *Lourdes Arizpe, Gabriel Ascencio Franco*, Danièle Dehouve Santos*, John Gledhill, Rosalva Aída Hernández Castillo, Françoise Lestage*, Xochitl Leyva Solano, Thierry Linck*, Valentina Napolitano*, Ronald Nigh, Marièlle Pepin-Lehalleur*, Susana Rostas, Robert C. Smith (* Chapters in Spanish).*

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