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## **VIII. A INTRA-LATIN AMERICAN TRADE IN THE 1990s AND ITS ANALYTICAL BASE\***

### **1. An analytical basis for PRAs**

Deep trade reforms have been undertaken in Latin America as part of a broad-ranging process of change in which international competitiveness and exports play a leading role. Most countries are looking for export-led development. Nonetheless, in contrast with the experience of East Asian nations, the main instrument of trade reform has been a rather indiscriminate and rapid liberalization of imports (see chapter III; and ECLAC, 1995, chapter V). Most LACs introduced reforms that could be described as drastic and sudden. Generally speaking, the tariff protection provided at present differs considerably from its pre-reform levels, and the spread of rates of effective protection has diminished substantially. For instance, the simple average external tariff was reduced from 45 per cent by the mid-1980s to 13 per cent ten years later. No country has yet adopted a zero tariff rate, however. These regional trends in trade policy have been complemented by a drive towards implementing bilateral or multilateral free trade agreements, covering a wide spectrum of items. The fact that tariffs are different from zero but are at moderate levels leaves space for reciprocal tariff preferences but with more limited trade diversion than in earlier trade integration programs.

The conventional literature on the benefits and costs of economic integration focuses on tariff preferences in a framework of optimal competitive equilibrium. This equilibrium is assumed to be disturbed only by the existence of import restrictions. In this framework, integration is beneficial only if it implies a move towards free trade: that is, if the effects of trade creation (shifts towards cheaper sources of supply) are larger than those of trade diversion (shifts towards more costly sources of supply). The crucial issue, however, is how costs are measured; in the standard approach it is at actual market prices net of tariffs, assuming away transitional costs and incomplete markets, as well as acquirable competitiveness. The assumptions lead to the obvious conclusion that overall unilateral liberalization is the optimal national policy and better than Preferential Regional Trade Agreements (PRAs).

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Why, then, do so many nations want to be involved in integration processes, even in these times of fashionable free trade? Regional integration builds on strategic considerations arising from imperfect and incomplete markets at home and abroad, which handicap the spread of efficiency gains in certain sectors and the development of new productive patterns with progressively higher degrees of value added and knowledge. The five issues that follow are related to trade in goods and services, and provide analytical bases to support regional integration arrangements with preferential import regimes. One crucial assumption we adopt is that regional integration takes place in a framework of open regionalism, with "moderate" external tariffs.

First, world markets are not widely open and stable. Nonetheless, they are broad; they grew 50 per cent faster than GDP in the last half century, and they have reached one-fifth of world GDP. However, LAC exports are concentrated in natural resource-based primary and semi-manufactured commodities. Thus, with or without participation in PRAs, world markets have been and will continue to be crucial for traditional exports of LACs; instability actually prevails in those markets, but it refers more to prices rather than to access (or volume). However, for many non-traditional products (including non-traditional natural resources), access to markets is more limited and unstable. It is for these type of products that PRAs become relevant to foster a diversifying growth of exports.

Second, given those distortions in access to world markets, economies of scale and specialization are more difficult to secure for an emerging country. To lock in improved access to regional foreign markets helps to make use of those economies, and in fact this achievement has been a leading target of policy-makers and a force encouraging regional integration. As a consequence, in face of economies of scale, what otherwise would be a costly trade diversion can become a cost-reducing and welfare-enhancing trade diversion (Corden, 1972; French-Davis, 1980).<sup>1</sup>

Third, domestic factors markets are incomplete or distorted. Labor training, technology and long-term capital are scarce, with non-existent or infant markets in LACs. These market failures are more significant for nontraditional exports of differentiated products, whether of natural resources, manufactures or exportable services. If access to external markets is improved for these exportables, it can strengthen the effectiveness of efforts to complete markets and dilute segmentation.

Fourth, infrastructure, trade financing and knowledge of markets (marketing channels, organized transportation, standards, etc.) are often biased against intra-regional trade in LACs. All these special "factors" of trade have been traditionally more developed for deals with the "center" while they are non-

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<sup>1</sup> The geometry of economies of scale and its welfare implications for trade diversion is presented in Corden (1972) and is

existent or more rudimentary for trade among LACs neighbors. This is one of the significant variables explaining why intra-regional trade has been lower among LACs than what the gravity of geography suggests.

Fifth, in economies reforming trade policies, sliding away from excessive and arbitrary protection for import substitutes and inputs of exportables, there tends to emerge significant transitional costs. These are enhanced if the reform is abrupt and if during the process the exchange-rate happens to appreciate, as it has been the case in most LACs in the 1990s.

East Asian nations minimized transitional costs in the 1960s and 1970s with an export-led strategy for opening to the world economy (see chapter III). That is, in their opening processes, nations like Japan, Korean Republic and Taiwan put stronger emphasis in export promotion than import liberalization; thus, in the transition period they provided a net positive balance of pulls for the domestic output of tradables (encouraging use of capacity and investment to increase that capacity). Given the LACs option for an import-led reform, a parallel process of regional PRAs becomes more attractive, in order to increase the efficiency of the productive transformation (ECLAC,1995). In fact, PRAs add a compensatory ingredient to unilateral import liberalization (and more so if the exchange-rate has appreciated in the process), fostering reciprocal exports in tandem with reciprocal imports. Hence, the doses of positive and negative pulls (impulses) to economic activity and investment are more balanced with PRAs, than is the case in pure unilateral import liberalization.

All these five points depict serious restrictions on the expansion of production and trade in goods and services relatively intensive in knowledge and longer learning curves, elements which are now recognized as key components of the growth process. Regional integration is a strategic tool which can help to partially overcome these obstacles (Devlin and Ffrench-Davis, 1998) by:

- (a) expanding market size to facilitate greater specialization and industrialization through economies of scale and the possibility of exploiting economies associated with the agglomeration of production activity;
- (b) enhancing the forces of competition, by enlarging a market with guaranteed reciprocal access, and intensifying the specificity of information flows, all of which tend to induce new domestic investment and attract efficient FDI. Creating the security of subregional market access, and exploiting the familiarity of neighborhoods, accelerates the emergence of new producers and traders of non-traditional exports. The learning curve associated with intraregional export experience can serve as a platform for subsequent new international exports. This is important since history has shown that developing countries must achieve new dynamic comparative

advantage on the road of their long term convergence with industrialized countries. The expected enhanced international competitiveness brought about by regional integration should build confidence and prepare countries for globalization and further advances in multilateral liberalization.

To appreciate the strategic dimension of integration, we can examine the profile of intra-regional exports. Intra- and extra-regional exports from Latin America display marked differences in terms of their product structure and technological content, with manufactures accounting for a much larger share of intra-regional commerce, as shown in table VIII-1 and VIII.2.

## **2. Intra-regional trade and enhanced quality of exports**

Total intra-regional exports tripled between 1990 and 1997. Initially it was principally a recovery from the sharp drop of the 1980s. However, given a notably rapid growth, shortly the previous peaks were regained. A record was achieved in 1992, with an additional jump in 1993-94. Subsequently, the Tequila crisis reduced the share of intra-regional exports, particularly those to Argentinean and Mexican markets, followed by a recovery in 1997. Nonetheless, MERCOSUR shows a persistently rising share of reciprocal trade among partner countries; it jumped from 9 per cent in 1990 to 24 per cent in 1997 (table VIII.1).

It is interesting to compare GDP growth, total exports and intra-regional exports (all in real terms). GDP of Latin America grew 22 per cent between 1990 and 1996, while total exports rose 59 per cent. Within these, intra-regional exports expanded 160 per cent, while to extra-regional markets they rose 44 per cent (i.e., faster than world trade) with a gross GDP elasticity of 2. These data support the hypothesis of open regionalism, with trade growing fast with all markets, but with a rising share to partners' destinations.

Table 8.1. INTRA-REGIONAL AND TOTAL EXPORTS, 1990-97  
(US\$ billions and percentage shares)

	1990	1991	1992	1993	1994	1995	1996	1997 <sup>c</sup>
<b>Andean Community</b>								
-Intraregional	1.3	1.8	2.2	2.9	3.5	4.8	4.7	5.6
-World	30.8	28.6	28.3	29.8	34.8	40.2	44.7	48.7
Andean Group/World (%)	4.1	6.2	7.8	9.7	10.1	11.9	10.5	11.5
<b>MERCOSUR</b>								
-Intraregional	4.1	5.1	7.2	10.0	12.0	14.4	17.0	20.2
-World	46.4	45.9	50.5	54.2	62.1	70.3	75.0	82.4
MERCOSUR/World(%)	8.9	11.1	14.3	18.5	19.3	20.5	22.7	24.4
<b>CACM</b>								
-Intraregional	0.7	0.7	0.9	1.1	1.2	1.5	1.6	1.8
-World	4.0	4.0	4.7	5.1	5.5	6.9	7.3	8.2
CACM/World(%)	17.3	17.4	19.8	22.4	21.8	21.1	21.2	22.2
<b>CARICOM<sup>a</sup></b>								
-Intraregional	0.3	0.2	0.2	0.3	0.3	0.4	0.5	-
-World	3.6	3.4	3.4	3.3	3.8	4.4	4.6	-
CARICOM/World(%)	7.1	6.5	6.5	9.0	8.8	10.0	10.6	-
<b>Latin America and the Caribbean<sup>b</sup></b>								
-Intraregional	16.1	19.4	24.4	29.1	35.4	42.2	45.6	53.7
-World	122.7	121.0	126.5	133.9	154.6	189.0	209.5	230.7
LAC/World(%)	13.1	16.0	19.3	21.7	22.9	22.4	21.8	23.3

<sup>a</sup> Only includes Barbados, Guyana, Jamaica, and Trinidad and Tobago. <sup>b</sup> Includes LAIA, CACM, Bahamas, Barbados, Belize, Dominican Republic, Guyana, Haiti, Jamaica, Panama, Suriname and Trinidad and Tobago. <sup>c</sup> Provisional figures.

Source: Calculations by the author, on the basis of official figures processed by ECLAC and IDB; exports of goods, excluding Mexican maquila.

#### a) The sources of intra-regional trade expansion

Some factors influencing current trends are the geography, the relaxation of a binding external restriction, a real exchange-rate appreciation and the implementation of PRAs.

*Geography.* Neighbouring areas, dense in capital and population, often tend to naturally interact and trade relatively more intensively with increasing specialization. Among the economic factors behind this are the positive externalities of location and agglomeration. The tendency can be further enhanced when income levels, cultures, tastes and languages are similar, as they are in Latin America, and when differentials exist in transport costs between contiguous and non-contiguous countries. On these criteria, large natural geographic areas of economic integration would appear to exist in Latin America in its

Southern Cone, Venezuela-Colombia-Ecuador, Central America and North America for Mexico. In fact, the boom in intra-regional trade has largely been among neighboring countries in the region (Devlin and Ffrench-Davis, 1998). Geography still matters a great deal.

*Release of the binding external restriction.* The decline of world interest rates, debt relief and a return of capital inflows in the 1990s (see chapter V; and ECLAC, 1995, ch. III) has dramatically increased import capacity in the region with a consequent reactivation of economic activity. Since intra-regional imports equal intra-regional exports, the generalized import boom has been reflected in the marked growth on intra-regional exports.

*Real exchange-rate appreciation.* The region's external trade performance has also been influenced by the exchange-rate behavior of Latin American and Caribbean countries. The simultaneous liberalization of the capital account in many countries, coupled with a surge in supply of foreign capital and the use of exchange-rate anchors in support of stabilization programs, contributed to real currency appreciations in an important number of countries (just when the opposite, a real depreciation, was needed to facilitate export-led growth). However, since real appreciation of exchange-rates with respect to the rest of the world has been simultaneous among a significant number of neighboring countries in Latin America in the 1990s, obviously there is no appreciation among them. As a consequence, the dampening effects on exports have been relatively stronger in the extra-regional market, encouraging exporters to redirect their sales toward regional markets.

*Subregional trade agreements.* The explosion of subregional and bilateral trade agreements in the 1990s has stimulated intra-regional trade through many mutually reinforcing effects, as listed below:

- (a) Trade preferences are an integral part of the regional integration agreements and provide incentives for intraregional trade. The absolute level of the preference over time will depend on the evolution of external tariff rates, given that internal tariffs have been approaching zero in several PRAs.
- (b) An increased flow of information and public attention on trade opportunities in an adjacent market (agreement-led growth in trade). There is evidence that unilateral trade liberalization has been a key factor in exposing natural market opportunities for exports to neighboring countries, that hitherto were hidden behind high national protection. Nevertheless, it is important also to point out that many of the preferences of the older trade agreements in the region have been progressively eroded by the unilateral liberalization of trade in the late 1980s and early 1990s; however, the effect of the significant reduction of internal tariffs affecting reciprocal trade predominates.
- (c) In contrast to unilateral opening, the free trade arrangements have given the private sector

reciprocal and legally binding market access which has reduced the risks of trade and investment barriers emerging in the affected market.

- (d) A preferential agreement can signal the continuing commitment of public authorities to trade expansion; in agreements such as MERCOSUR, subregional trade liberalization is accompanied by an additional commitment involving a broad political message, pursued at the highest official level, to promote deep economic integration and political cooperation among member countries. This in turn increases private sector confidence, which can lead to the execution of irreversible investment.

#### **b) The composition of reciprocal trade and technological intensity**

The profile of intra-regional trade contributes to a drastic change in the composition of LAC exports: the predominance of primary exports was partially replaced by manufactures, which now account for half of intra-regional trade. This notable increase in manufactured exports corresponds especially to new industries, including both labour-intensive and capital-intensive activities.

The Latin American economies provide very dynamic markets for the sales of manufactures for several LACs (ECLAC, 1995, ch. III). For Chile, Colombia and Ecuador this is by far the main market, be it for traditional industries, basic inputs or new industries. This concentration is not so marked in the cases of Argentina, Paraguay and Uruguay; they have a considerable diversification of markets for their traditional industries and, in Argentina, also for the basic-input industry; however, Latin America continues to be the almost exclusive destination for exports from the new industries of these countries. The same is true of their subregional market as regards the new industries of Costa Rica and Guatemala. Brazil has channelled its export manufactures to different markets. The USA continues to be the main buyer of Brazilian traditional products, followed by Europe; as for basic inputs, other developing regions have displaced Latin America as the main destination, but in the case of new industries, the region is the most important market for Brazil. An exception is the case of Mexico, where the regional market holds a notably lower share than the USA. It is highly relevant to notice that border trade (with neighbour countries) represents the bulk of intra-regional trade, a new proof that geography matters.

Development based on a growing and sustained international competitiveness is boosted by the dynamic effects derived from technological apprenticeship. The strategies to improve international linkages, based on productive development, emphasize the role played by trade in the process of stimulating the development of activities which make intensive use of knowledge and technology, and generate externalities.

In this sense, it is a common belief that trade among LDCs is characterized by goods that are more technology-intensive than exports to industrial countries. Data for LACs confirms the validity of that assumption, as shown by table VIII.2.<sup>2</sup>

*Table VIII.2* LATIN AMERICA (14 COUNTRIES)<sup>a</sup>: COMPOSITION OF EXPORTS  
BY DESTINATION, 1970-74 AND 1995  
(In percentages)

	Intra Latin America		World	
	1970-74	1995	1970-74	1995
A. Primary commodities	51.0	19.7	53.6	32.2
1. Agricultural products	11.7	10.3	29.9	16.0
2. Mining products	1.0	2.4	6.2	4.0
3. Energy products	38.3	7.0	17.6	12.2
B. Industrialized products	48.8	79.7	46.0	65.6
1. Semi-manufactures	23.3	29.9	33.6	30.5
1.1 Based on agriculture and labour-intensive	7.5	10.3	9.5	11.9
1.2 Based on agriculture and capital-intensive	3.1	4.8	6.0	5.2
1.3 Based on minerals	6.4	8.4	9.2	9.1
1.4 Based on energy	6.2	6.5	8.9	4.4
2. Manufactured goods	25.5	49.8	12.4	35.1
2.1 Traditional industries	7.2	12.4	5.2	8.4
2.2 Basic-input industries	4.8	10.2	1.9	7.2
2.3 New labour-intensive	7.0	10.7	3.0	8.3
a) Medium technological content	4.1	6.3	1.6	4.5
b) High technological content	3.0	4.4	1.4	3.8
2.4 New capital-intensive	6.5	16.6	2.3	11.2
a) Medium technological content	5.0	14.7	1.7	10.1
b) High technological content	1.5	2.0	0.6	1.2
C. Other	0.2	0.5	0.4	2.2
<b>Total</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>

<sup>a</sup> Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Ecuador, Guatemala, Honduras, Mexico (excluding maquila), Paraguay, Peru, Uruguay and Venezuela. Exports with low technological content are summed up with traditional industries.

*Source:* ECLAC (1995), table III.9, on the basis of official data.

Table VIII.2 shows how intra-regional exports are more intensive in technology, particularly advancing from low to medium technological content, and thus more suited to the semi-industrialized stage of Latin America.

The same conclusion is also corroborated in an ECLAC study (1994, ch. II) which combines data on foreign trade and on production. The figures show that products which encounter a relatively high

<sup>2</sup> Another way of putting that assumption is that intra-LDC trade tends to be capital intensive unlike to trade with industrial nations. This line of thought, in a static approach, assumes that trade with rich countries is more convenient for LDCs.



share of their demand in the regional market exhibit more advanced technological characteristics than exports channelled towards extra-regional or domestic markets. Thus they can contribute with larger externalities to the domestic economies.

From the research carried out for ECLAC (1994), three main conclusions emerge: first, that the production of goods which depend to a greater extent on intra-regional trade has more sophisticated technological features. Such goods are to be found mainly in the chemical sector, non-electrical machinery and transport equipment. These are also sectors in which international demand tends to be more dynamic. Their price trends tend to be more stable and evolve more positively over the long term than prices of traditional exports.

Second, the sectors which exhibit a strong export bias toward the region also tend to show (sometimes with a lag) a drive towards extra-regional markets, which suggests that the promotion of intra-regional trade complements the promotion of extra-regional exports.

Third, these same sectors are those in which the region has a high dependency as regards extra-regional intermediate imports, and therefore intra-regional trade benefits from having access to inputs and equipment which may be imported from third countries. Thus, relaxation of excessive import restrictions has contributed to foster and upgrade exports.

To sum up, intra-regional trade, because of its characteristics which are associated with vicinity and similarity of development levels, complements the LACs' linkages with the global economy and provide a dynamic context of technological apprenticeship, leading to greater international competitiveness and a more diversified, balanced pattern of specialization.

Additionally, given the macroeconomic conjuncture by the early 1990s, reciprocal trade also made a rather neo-Keynesian contribution to the LACs' economies. In fact, the encouragement to intra-regional exports has increased the demand for domestic resources and for investment; this is positive for growth and efficiency in a framework of economies operating below the production frontier and conducting import liberalization. Tariff preferences, removal of reciprocal import restrictions and creation of additional outlets for domestic output (harmonization of standards, transportation, improved infrastructure, marketing channels, reciprocal investment, etc.) have contributed to increase the rate of use of resources and to encourage some productive investment.