TOWARD A SUSTAINABLE FTAA: DOES LATIN AMERICA MEET THE NECESSARY FINANCIAL PRECONDITIONS?

Liliana Rojas-Suarez
Visiting Fellow, Institute for International Economics
Nonresident Fellow, Center for Global Development

Abstract

This paper focuses on identifying preconditions that will ensure the sustainability of a Free Trade Area of the Americas (FTAA). It argues that the macro, micro, and political conditions advanced in the literature to measure a country's ability to compete internationally, while necessary, are not sufficient to ensure the success and permanence of a free trade agreement. Instead, two additional financial conditions are needed. The first is that each partner in the free trade area needs to have sustainable public debts as determined by the achievement of credible and sustainable structural fiscal balances. The second is that exchange rate regimes across trading partners should be compatible in the sense that adverse shocks in one country do not generate a policy dilemma in other partners between abandoning their exchange rate system or the free trade area.

A preliminary analysis of the evidence in the Latin American and Caribbean region shows the importance of these two preconditions. An analysis of debt sustainability reveals that there are a number of countries in the region that need to deal with potential solvency problems before reaching the status of credible partners in a regional trade arrangement. Argentina is already deemed insolvent, and countries such as Ecuador and Venezuela rank high on the list of countries where the issue of debt sustainability can become a serious problem. Not resolving this before reaching a regional trade agreement can threaten its long-term stability.

The examination of the compatibility of exchange rate systems across trading partners is also very revealing. Part of the success of NAFTA since the late 1990s and the "impasse" of Mercosur during 1999-2001 had to do with the choices of exchange rate regimes. In both trade areas the share of trade among the partners is very high, and in NAFTA, this includes significant financial transactions. While Mexico was able to use the flexibility of the exchange rate to improve competitiveness following the sharp decline of portfolio flows from US investors into Mexico following the Asian and Russian crises, Argentina had no mechanisms to deal with an adverse shock from Brazil (such as a depreciation of the real in 1999). From this perspective, the recent move of Argentina towards a more flexible exchange rate system is good news for a sustainable free trade area.

Author's note: I would like to thank Gary Hufbauer, Jeffrey Schott, and participants of an NAEFA seminar organized at the 2002 Meetings of the American Economic Association for their valuable comments and suggestions, and Trond Augdal for excellent research support and valuable comments. The errors that remain are, of course, my own.

I. INTRODUCTION

This paper deals with the feasibility and sustainability of regional trade integration in the Americas as envisaged by the Free Trade Area of the Americas (FTAA).

The benefits from achieving regional trade integration in the Americas have been discussed extensively.[1] In a nutshell, the eventual elimination of trade barriers is expected to generate large increases in trade and investment flows that would benefit all member countries. To many, regional trade integration is perceived not only as a natural element of the process of globalization but also as an essential ingredient to reach the ultimate goal of sustained growth and development that has proved so elusive for most of the countries in the region.[2]

It is well-known that the vision of regional integration in Latin America is an old one, whose origins can be traced back to the so-called "Bolivar's dream" of a unified Latin America in the 19th century. Initiatives for sub-regional free trade arrangements abounded during the 20th century.[3] However, due to either insufficient commitment among governments involved and/or inconsistent policies among trading partners, most of these efforts cannot be classified as successful. It took the North American Free Trade Agreement (NAFTA), signed by Canada, Mexico, and the United States in 1992, to clearly demonstrate the potential and long-lasting benefits of trade integration. NAFTA also made Latin American countries realize that a less developed member of a free trade agreement with industrialized economies can reap significant benefits from such a partnership.[4]

The increasing interest in the "trade agreements model" as an alternative approach to sustained growth in Latin American countries has also been motivated by recent developments in international capital markets. To a significant extent, economic growth during most of the 1990s in the Latin America and the Caribbean region (LAC) was sustained by large net private capital inflows. These inflows allowed for a combination of trade deficits and accumulation of foreign exchange reserves in the region. Since the eruption of the emerging-market crisis in the late 1990s, however, net private inflows in the region (especially portfolio flows) have decreased

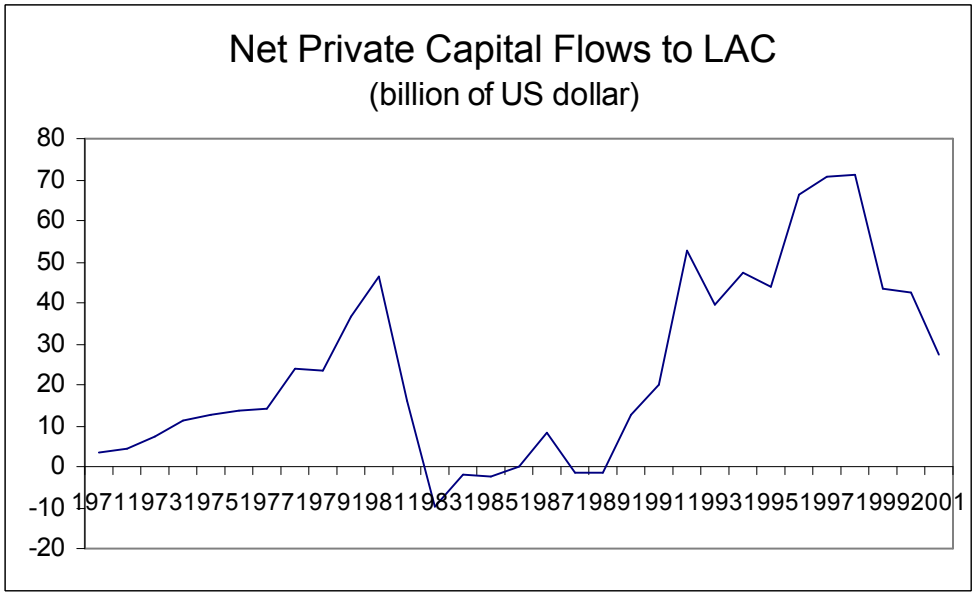
1. See, for example, Iglesias (2001), Schott (2001), and Pastor (2001).
2. In the words of the president of the Inter-American Development Bank, "Regional integration is not an end in itself but is an instrument to support a strategy of economic growth and development."
3. A comprehensive account of these initiatives is contained in Iglesias (2001).
4. Some of the most impressive achievements attributed to NAFTA include: (a) a more than double increase in exports among the three trading partners, (b) a dramatic decrease in the dependence of Mexico's exports on oil (while in the early 1980s oil accounted for more than 70 percent of exports, in the late 1990s that ratio had been reduced to only 5.5 percent), (c) a surge in investment flows among the three countries, and (d) an impressive increase in *net* creation of jobs (new jobs related to NAFTA overwhelmingly surpassed jobs lost associated with the trade agreement. These issues are extensively discussed in Weintraub (1997) and Hinojosa et al. (2000).

dramatically. (See chart 1.) Recollections of the so-called "lost decade of Latin America" during the 1980s, when the region lost access to private sources of external capital, linger in the memory of policymakers. During the 1980s the average annual rate of economic growth reached a mere 1 percent, with several years recording negative growth. Trade surpluses financed the transfers of resources abroad to service large accumulations of debt.

Forecasts of capital flows to LAC are not encouraging. For example the IMF (2002) forecasted that total net private flows in 2002 will decrease significantly with respect to their level in 2001 (US$27.1 billion vs US$37.7 billion). Moreover, net private portfolio investment into the region is forecast to reach about US$7.6 billion. This figure compares with an average of over US$20 billion in the mid-1990s.

The renewed interest by a number of policymakers in LAC in the trade integration approach is, therefore, consistent with the current adverse international financial environment.[5] After all, as learned from the experience of NAFTA, successful trade agreements have been an efficient mechanism to attract sustained inflows of foreign direct investment.[6]

Chart 1



Source: IMF World Economic Outlook (April 2002).

5. The 2002 debt crisis in Argentina further aggravated the international financial environment facing LAC countries. Financial-market jitters in mid-2002 over forthcoming elections added to this.
6. Evidence from Mexico is a case in point. Even facing a sharp fall in the ratio of growth of exports during 2001 (largely due to the recession in the United States), foreign direct investment toward Mexico

The process towards trade integration has furthermore benefited from two developments in late 2001-02: the agreement in Doha for a new round of world trade negotiations and significant (albeit slow) progress towards the approval of Trade Promotion Authority (TPA) to the US President (formerly known as "Fast Track").[7] The importance of TPA approval for the multiplicity of bilateral trade agreements between LAC countries and the United States, and ultimately for the achievement of FTAA, cannot be overstated. The approval of TPA would be the strongest signal in recent years of US commitment towards free trade, and several countries in LAC, therefore, may be encouraged to accelerate FTAA negotiations. After all, gaining political consensus, both in governments and congresses in the region, about the key importance of free trade agreements for sustainable growth, is what is needed for the completion of FTAA negotiations by 2005.[8]

However, even if commitment towards an FTAA is gained and the negotiations are actually concluded in 2005, what guarantees that such an agreement will be successful and permanent? After all, Latin America is full of experiments of trade negotiations that, after a short period of enthusiasm, were eventually either abandoned or given a very low priority on the policy agenda. In other words, what are the preconditions for the *sustainability* of an FTAA even if negotiations are completed by 2005?

This paper argues that certain policy requirements are needed at the country level to ensure the permanence of an FTAA. The basic premise behind the need for these requirements is that a policy regime, such as a free trade area, will not be permanent if adverse and unanticipated shocks create strong incentives to abandon the regime.[9] In identifying key prerequisites for a sustainable FTAA, this paper complements previous studies that focus on testing whether countries in the LAC region are economically and politically prepared to meet the demands of an FTAA.

While recognizing that a number of macro, micro, and political variables identified in previous studies are essential, this paper argues that there are additional *financial* conditions

---

remained strong. In other words, perceived temporary adverse effects affecting exports do not seem to distract investors from the potential permanent benefits of long-term investment.

7. Trade Promotion Authority (TPA) allows the US president to negotiate trade deals and bring them back to Congress for an expedited, up-or-down vote. Amendments are not allowed.

8. For example, Brazil had made the approval of fast-track authority a condition for engaging in serious FTAA negotiations.

9. We can draw a parallel with the need to satisfy certain pre-conditions for the stability of a fixed exchange rate regime. For example, a country following a fixed exchange rate system will find it very troublesome to defend the peg in the presence of an adverse shock if the country's banking system is weak. The reason is that to defend the parity the authorities may need to increase domestic interest rates, which in turn would hurt already fragile banks. Experience shows that if forced to choose, most countries would let

necessary to *preserve the sustainability* of the *trade* integration efforts. The paper claims that these additional preconditions are: (a) sustainable public debts as determined by the achievement of "*credible" and "sustainable" structural fiscal balances* and (b) compatible exchange rate regimes across trading partners. The paper argues that studies failing to evaluate progress towards reaching these conditions will not be able to appropriately assess individual countries' capacity to join the FTAA on a sustainable basis.

The rest of this paper is organized as follows: Section II justifies the need for identifying *financial* prerequisites ensuring the sustainability of trade integration efforts and elaborates on them. Section III empirically examines whether countries in the LAC are satisfying these requisites. Section IV concludes the paper.

II. NECESSARY FINANCIAL PRECONDITIONS FOR FTAA SUSTAINABILITY

The need to identify policies that ensure FTAA sustainability arises from the nature of the proposed agreement. In contrast to other more comprehensive regional integration efforts, such as the European Union, the FTAA does not envisage the creation of regional institutions to deal with collective problems. As is NAFTA, the proposed FTAA is only a trade area, not a "community" sharing common rules in a variety of economic aspects beside trade. In analyzing NAFTA, Pastor (2001) has stressed the important shortcomings that derive from the absence of supra-national institutions able to enforce policy decisions aimed at ensuring the continuous improvement of the integration arrangement. Pastor argues that a major shortcoming in the NAFTA charter is that it assumes that the social, economic, and political consequences of dismantling trade and investment barriers will be trivial. In his own words, "NAFTA…overlooked the concept of externalities…that markets generate unintended but costly social, environmental, and political consequences" (Pastor 2001, 5). I fully agree and argue that similar, but even larger problems would arise with an FTAA—simply by the sheer diversity of the large number of countries involved.

However, while I concur with those analysts strongly supporting the creation of supranational institutions,[10] I take a more pragmatic view and assume that such supranational institutions will not be in the making in the medium term; the political consensus needed for the creation of such institutions does not exist. Instead, I ask what policy actions at the *national* level could allow for the sustainability of free trade in the Western Hemisphere. It is my view, that in the absence of supranational institutions with enforcement powers to ensure the permanence of

---

the peg go rather than creating a financial collapse. It follows, therefore, that a key pre-condition for a stable peg is a sound banking system.

the regional integration process by dealing with the externalities, it is vital for policymakers in the region to identify essential conditions for FTAA sustainability.

This section has two parts. The first part summarizes recent research about economic and political conditions in the LAC region that have been identified as necessary for countries to effectively lift trade barriers and, therefore, to successfully join a free trade area. The second part proposes two additional *financial* conditions necessary to secure not only the ability of a country to join a trade agreement but to make such an arrangement sustainable.

What Can We Conclude from Recent Research About the Appropriateness of Economic and Political Conditions in LAC Countries to Join Free Trade Agreements?

As stated in the introduction, this paper should be seen as a complement to previous studies that have tested whether countries in the LAC region are prepared, both in economic and political terms, to join an FTAA. The most comprehensive analyses can be found in Hufbauer and Schott (1994) and Schott (2001). The authors develop "readiness indicators", a set of macro (price stability, budget discipline, national savings, external debt and currency stability), microeconomic (government's reliance on market-oriented policies and on trade taxes as a form of tax revenue) and political (index of political rights and civil liberties, index of health, education and per-capita income) variables that, when combined, allow for the assessment of "the capacity of a country to compete in the global market place" (Schott, 2001, 17).[11] Countries can then be ranked according to readiness indicator scores (see table 1, first column).

10. Including, among others, Grinspun and Kreklewich (2001), Grubel (2001) and Pastor (2001).
11. The basic idea in the Hufbauer and Schott papers is that the more stable a country is in terms of its economic performance and the more advanced a social agenda is in terms of securing human rights and social services, the more "ready" it is to join the FTAA.

Table 1 Alternative ranking of LAC countries according to economic/ political advances in reform

Schott (2001): Readiness Indicator[2]		World Economic Forum (2001): Growth Competitiveness Index[1]		Lora (2001)[3] Index of Structural Reform[3]	
Barbados	1	Chile	1	Bolivia	1
Chile	2	Costa Rica	2	Jamaica	2
Uruguay	3	Trinidad & Tobago	3	Peru	3
Costa Rica	4	Mexico	4	Trinidad & Tobago	4
Trinidad & Tobago	5	Uruguay	5	Argentina	5
Mexico	6	Dominican Republic	6	Brazil	6
Argentina	7	Brazil	7	Chile	7
Bahamas, The	8	Panama	8	Dominican Republic	8
El Salvador	9	Jamaica	9	Nicaragua	9
Venezuela, RB	10	Argentina	10	Guatemala	10
Panama	11	El Salvador	11	Paraguay	11
Bolivia	12	Peru	12	El Salvador	13
Grenada	13	Venezuela, RB	13	Colombia	14
Paraguay	14	Colombia	14	Costa Rica	15
Peru	15	Guatemala	15	Ecuador	16
Colombia	16	Bolivia	16	Venezuela, RB	17
Belize	17	Ecuador	17	Honduras	18
Honduras	18	Honduras	18	Mexico	18
St. Lucia	19	Paraguay	19	Uruguay	19
Dominican Republic	20	Nicaragua	20		
Dominica	21				
Brazil	22				
St. Kitts & Nevis	23				
Jamaica	24				
St Vincent and Gren.	25				
Guatemala	26				
Guyana	27				
Antigua & Barbuda	28				
Ecuador	29				
Nicaragua	30				
Suriname	31				
Haiti	32				

1. The Growth Competitiveness Index is formed by three sub-indices: (a) macroeconomic environment index; (b) public institutions index; (c) technology index.
2. Schott's readiness indicator is composed of three sub-indices: (a) macroeconomic indicator; (b) market indicator replicating the government's reliance on market-oriented policies and on trade taxes for tax revenue collection; (c) policy sustainability indicator.
3. Lora's index of structural reforms is a simple average of five sub-indices in the following areas: (a) commercial policy; (b) financial policy; (c) tax policy; (d) privatization; (e) labor policy. The index is calculated every year during the period 1995-99. The data presented corresponds to 1999.

Sources: World Economic Forum (2001); Schott (2001); Lora (2001).

While not focusing particularly on the FTAA, the World Economic Forum (WEF 2001) produced the "Growth Competitiveness Index", an indicator aimed at identifying the factors explaining a country's ability to produce efficiently goods and services at international standards of technology and quality. The index is produced by a combination of three sets of variables: (a) those affecting the quality of the macroeconomic environment (inflation, interest rate spreads, fiscal stance, national savings rate), (b) those affecting the quality of public institutions (the quality of "property rights, the rule of law" and the degree of corruption) and (c) those reflecting technological progress (companies' investment in R&D, level of tertiary education, degree of "absorption" of foreign technology, degree of advance in information and communication technology). The LAC countries included in this study are ranked according to this index in column 2 of table 1.

Not surprisingly, there is significant overlapping between some of the variables in Schott's "readiness indicator" and the WEF "competitiveness index," particularly among the macroeconomic variables. Indeed, as appendix I shows, the similarities between these macroeconomic stability indices are large enough to have important coincidences in the ranking of countries, especially at the top and bottom of the ranking.[12] The key difference between the two indicators, and an important contributor explaining the different ordering of countries in the "overall indicators," is the inclusion of "technology" variables in WEF.

In contrast to Schott and WEF, Lora's (2001) index of structural reform does not aim directly at measuring and comparing countries' capacities to compete internationally. Lora's objective is to assess the depth of policy reforms in five areas: (a) commercial policy, (b) financial policy, (c) tax policy, (d) privatization, and (e) labor policy[13]. This index can, therefore, be seen as a complement to the "market-oriented policies" indicator in Schott. The ranking of countries according to the index of structural reforms is presented in column 3 of table 1.

Due to the narrower scope of the Lora's study, rankings of countries based on the index of structural reform are not comparable with those of Schott and WEF. For the latter two, however, there are both impressive similarities and quite contrasting results in the rankings. For example, excluding from the Schott sample the countries not included in the WEF study, the five best performers are the same (but in different order) in the two alternative studies (Chile, Costa Rica, Mexico, Trinidad & Tobago, and Uruguay). There is also agreement that Nicaragua and Ecuador are the worst performers, and therefore, the least ready to join the FTAA (see table 1).

12. Out of the six best performers in terms of macroeconomic stability, four countries are common to both indices. Similarly, five out of the seven worst performers are common to both indices. See appendix I.

On the other hand, the two indices rank Brazil, the largest partner in the proposed FTAA, very differently. While Brazil takes position number 7 in the WEF ranking, it goes all the way down to position 16 in Schott's (when including only countries ranked by both indices). Likewise, Venezuela takes the 8th position in Schott's ranking (also including only countries ranked by both indices), while it is classified in the 13th position by the WEF methodology. Albeit at different degrees of discrepancies, there is no consensus about the relative position of the rest of the countries in the LAC region.

A comparison between studies, therefore, reveals that a small number of countries can be identified as economies either in the "relative best" or the "relative worst" position to compete internationally, while sharp differences persist regarding the relative "competitiveness" position of the majority of countries in LAC. Notice, however, that, as late as 2001, none of these studies classified Argentina as a "bad performer". Indeed, Argentina ranked 7th in Schott's (out of 32 countries), 10th in the WEF ranking (out of 20 countries) and 5th in the Lora's index (out of 19 countries). Based on the overwhelming problems that affected Argentina since 1999 that ended in the country's debt default in early 2002 and the deepest economic crisis in recent Latin American history, Argentina should have been ranked low for "readiness". What has been missing in current research that prevent the identification of severe potential problems to "credibly" join the FTAA? This is the subject of the next section.

Further Conditions Needed to Ensure Successful and *Sustainable* Free Trade Agreements

While I recognize that the variables identified by recent research are necessary to assess the capacity of a country to join a free trade area, I argue that those variables are not sufficient to ensure the sustainability of an integration effort. As stated in the introduction, the experience in Latin America has repeatedly shown that policy regimes often are abandoned after large and adverse unanticipated shocks create incentives to reverse existent policies, even when these policies involve international agreements.[14] I, therefore, suggest that two additional policy requirements, both aimed at *containing incentives to break the rules* under a free trade agreement, need to be satisfied. The first is sustainable public debts as determined by the achievement of *credible and sustainable structural fiscal balances*. The second is compatible exchange rate systems across trading partners. I now proceed to expand on these two policy conditions.

---

13. To my knowledge this is the most complete study of advances in the reform process in the LAC region.
14. As stated by Iglesias (2001), most of the early post-war trade agreements in Latin America "fell into open crisis in the 1980s" (128). This is not surprising as the 1980s can be characterized as the worst crisis period (in terms of both duration and intensity) in recent Latin American history.

Sustainable Public Debts

My claim that the criterion of credible and sustainable public debts is essential for the success of trade agreements in the LAC region is based on its long history of crises: From the debt crisis of 1982 to the tequila crisis of 1994-95 to the ongoing crisis in Argentina, a common root can be identified: unsustainable public debts.

To use a more recent episode, take, for example, the so-called "impasse" in Mercosur in 2000-01, just before Argentina's default.[15] Confronted with increasing problems in servicing its public debt (external and internal), Argentina's authorities faced during the period 2000-01 serious pressures for either abandoning or at least relaxing tariff commitments under Mercosur. To those opposed to the trade agreement, it was difficult to understand why the Argentine government did not increase revenues from external trade sufficiently to compensate for the sharp reduction in domestic tax collection that accompanied the deep recession that had inflicted the country for three consecutive years.[16] Regardless of the pros and cons of that argument, the key issue is that a major policy inconsistency, such as unsustainable public debt, provides strong political incentives to deviate from integration agreements when it is perceived that the costs from such accords exceed their benefits.

It is important to define what is meant here by public debt sustainability. After all, the recent studies surveyed in the previous section include several indicators of fiscal stability: fiscal deficit as percentage of GDP and external debt as percentage of exports in Schott's readiness indicator and levels of public spending in the WEF competitiveness index. The concept of public debt sustainability used here has two components. The first relates to a country's *capacity* to service its debt on a sustainable basis, and the second refers to a country's *willingness* to service its obligation. The first component involves using the well-known methodology advanced by Blanchard and further elaborated by Talvi and Vegh (1998). They define public debt as being sustainable if, under reasonable assumptions of economic growth and interest rates, a country is able to generate *structural* primary fiscal balances that would allow keeping constant the ratio of debt to GDP. The *structural primary fiscal balance* is obtained by stripping the cyclical or temporary components from the observed primary balance results. An important benefit of this methodology is that it eliminates large one-time events that temporarily inflate government revenues and, therefore, could give the impression of sustainability to debt services that are unsustainable in the medium-term.[17]

15. See, Intal (2001).
16. Indeed, in 1999 Argentina increased tariffs on a number of items.
17. As will be discussed in the next section, Venezuela, where the fiscal stance is highly dependent on the very volatile price of oil, is a case in point.

A key reason for my preferring this indicator of a country's capacity to service its debt over traditional ratios of fiscal soundness, such as debt to exports or debt to GDP (ratios used in the Schott and WEF studies), is that although these ratios have the benefit of being easy to calculate and readily available, they can be seriously misleading at a given point in time. Take Argentina once again. Throughout the long gestation period of the Argentine crisis (1999-2001) it was not unusual to hear some analysts claim that the country did not have a debt problem. The argument was that the ratio of government debt to GDP in Argentina (49 percent by end 2000) was much smaller than that of several developed countries, such as Italy (111 percent by end 2000)! The obvious mistake made by supporters of this argument is that they ignored that what matters is not the stock of debt itself but the overall capacity of the country to service that debt, and that such servicing capacity depends crucially on the country's ability to maintain *continuous* access to the international capital markets. While industrialized countries (a category that includes Italy) do not confront "sudden stops" of capital inflows when facing economic difficulties, lack of access to private external sources of finance has been a typical feature of LAC countries during crises.

The second component of the concept of debt sustainability used here, namely, the country's *willingness to pay*, is related to market perceptions about the government's political attitude toward its creditors. International perceptions about a country's "creditworthiness," as manifested in the spread between the yield on sovereign bonds and the yield on US Treasury bonds, reflect not only the market estimation about a country's capacity to generate necessary fiscal surpluses to service its obligations but also the government's *commitment* to sustain these balances *and* to use the proceeds to pay its liabilities.

I believe that this second component of debt sustainability is as important as the first component. Consider the example of Brazil in mid-2002. As will be shown in section II, it is easy to demonstrate that Brazil was moving towards a sustainable debt path, from the point of view of establishing its *capacity to pay*. However, in early June of 2002, electoral polls showed a significant increase in the probability of a presidential candidate, Mr. da Silva (Lula) to win the elections later that year. Because the markets perceived Mr. Lula as a "populist," fears developed about a potential future Brazilian government's commitment to continue on a sustainable debt path.[18] By end-June 2002, spreads on sovereign bonds had skyrocketed. The extremely high spreads raised the country's external financing costs and limited the availability of external sources of finance. The consequent balance of payments pressures translated into a depreciation

18. "Lula" had also stated in the past that Brazil should default on its debt.

of the exchange rate, which, in turn, aggravated the debt situation (due to the large proportion of dollar-denominated debt) and required further fiscal adjustments.

At the time of this writing, it was too early to know how the Brazilian story would end, but the basic message from this experience is that due to deteriorated perceptions of creditworthiness (in the Brazilian case, due not to the current but to the expected actions of a future government) a country may find itself "willing to prove the market wrong." In that situation, incentives for finding additional sources of government revenue will emerge because of the need to raise funds to continue servicing the government debt. Pressures for abandoning a "low tariff approach" may develop, risking the sustainability of a free trade agreement.

Evidence on debt sustainability based on the concepts discussed above will be presented for a selected sample of LAC countries in section III. I will then analyze how use of these criteria affects the conclusions from previous studies regarding the capacity of a country to join (and I add, on a sustainable basis) a free trade area.

Compatible Exchange Rate Regimes Across Trading Partners

Can a regional trade area be sustainable if its members follow different exchange rate regimes? This highly debatable question has resulted in quite different answers.[19] To some, integration arrangements need to share a common currency to be sustainable.[20] These analysts base their assessment on the experience of the European Union. The currency crisis of the ERM (Exchange Rate Mechanism) in 1992 is cited to demonstrate that not even a fixed exchange rate system is sufficient to ensure the stability of an integration process; instead trade integration is perceived as the first step towards higher degrees of economic and financial integration, culminating in the adoption of a single currency.

To others, however, all of the integration advances in the LAC region, whether NAFTA, the Andean Community or the FTAA, are just efforts towards free trade areas, with no intention—so far—of establishing a common market *a la* European Union and, even less, a monetary union. This latter view is held by most governments in LAC and by multilateral organizations. The straightforward conclusion from this view is that countries are free to choose their exchange rate system and that such choices need not impose a constraint on the success of an FTAA.

19. For an analysis of a number of issues related to this subject, see Fernandez-Arias et al. (2002).
20. See, for example, Grubel (1999).

I do not fully agree with either of the above two conclusions. While I believe that different exchange rate regimes can co-exist within the proposed FTAA, I think that there are some incompatibilities that need to be avoided.

Once again, recent events in Mercosur come in handy to illustrate my point on how such incompatibilities may arise. While, by no means, one can put the blame of Argentina's financial crisis on the Brazilian devaluation of 1999, it is certainly clear that the chosen exchange rate regimes of the two trading partners between 1999 and 2001 (a totally fixed exchange rate system, through the convertibility law, in Argentina and a flexible exchange rate regime in Brazil) was a call for potential trouble that, on a number of occasions, came close to undermining the sustainability of the trade agreement.[21]

A convergence of "adverse shocks" hit Argentina in 1998-99. First, the Argentine peso, pegged one-to-one to the US dollar, experienced a large real appreciation, thus hurting its ability to compete against its major trading partner: Europe. Partly due to the loss of international competitiveness, Argentina entered a recession and domestic investment declined significantly. Second, in the midst of the recession, Brazil devalued its currency against the US dollar. The devaluation implied that Brazilian consumers found imports from Argentina relatively more expensive, while Brazilian products became relatively cheaper to Argentinean consumers. Since Brazil is the second largest trading partner for Argentina, the Brazilian devaluation hit Argentina by further curtailing its sources of growth and, therefore, exacerbated the recession.

This event brought heated academic and political discussions: were Mercosur and the important share of Argentina's trade with Brazil the culprits for Argentina's exacerbated problems or was Argentina's convertibility the straitjacket that did not allow Argentina to regain competitiveness? To some, the problem even had a "moral" dimension: was the Brazilian change of exchange rate regime (it had a "crawling band" before 1999) "fair" to Argentina in the context of Mercosur?

While different views will certainly remain about this episode, the lesson that I derive is that two trading partners on the opposite extremes of the exchange rate-regime spectrum (fully fixed and fully flexible) can only be sustainable if each has a quite diversified trade pattern, that is, trades extensively with other countries. If, by contrast, there is high interdependence in trade between the two partners, the trade arrangement will tend not to be sustainable as an adverse shock hitting the flexible exchange rate country will severely affect the fixed exchange rate

21. In early 2002, Argentina abandoned the convertibility law and moved to a managed float of its exchange rate.

partner. This would create incentives to abandon the free trade agreement between the two member states.

Section III will review the current combination of exchange rate systems in order to assess whether major incompatibilities affecting the sustainability of free trade agreements are present in the region.

III. CAN A FREE TRADE AREA FOR THE AMERICAS BE SUSTAINABLE? A BRIEF ANALYSIS OF THE *SUSTAINABILITY INDICATORS*

This section briefly analyzes whether the sustainability conditions discussed above are met in the LAC region. The analysis is not meant to be exhaustive and will not cover all countries in the region due to lack of data readily available. Instead, the analysis is intended to shed light on the additional efforts that some countries in the region need to undertake if a free trade area, such as the FTAA, is going to become a permanent arrangement.

Are Public Debts Sustainable in Latin America?

To derive an assessment of public debt sustainability in Latin America, let us start by considering the first component of public debt sustainability discussed in section II, namely, a country's capacity to service its debt. A recent study by Ghezzi et al (2001) estimates the *structural* primary fiscal balances needed to achieve sustainable public debts in several Latin American countries. Table 2 presents their results for Brazil, Colombia, Ecuador, Mexico, Peru, and Venezuela.[22]

22. Using this concept is irrelevant for Argentina at this stage as the government defaulted on its debt in late 2001 and, at the time of this writing, there was no clear resolution process under way.

Table 2 Primary Fiscal Balances Needed to Achieve Sustainable Public Debts in Selected Latin American Countries (percent of GDP)

	Brazil	Colombia	Ecuador	Mexico	Peru	Venezuela
Primary balance in 2000	3.1	0.7	7.6	1.5	-0.8	4.1
Temporary	1.0	0.6	3.5[1]	0.8	-0.3	6.0[1]
Structural	2.1	0.1	4.1	0.7	-0.5	-1.9
Sustainable structural primary balance	2.1	2.0	6.2	1.4	0.9	1.8
Required adjustment over the medium-term	0.0	1.9	2.1	0.7	1.4	3.7
of which:						
in 2001	0.0	0.8	0.0	0.6	n.a.	n.a.
Medium-term gap	0.0	1.1	4.1	0.1	n.a.	n.a.

1. Entirely due to high oil prices.

Source: Ghezzi et al. (2001).

The methodology in table 2 involves three steps to assess debt sustainability from the perspective of a country's *capacity* to service its debt. In the first step the sustainable "structural" primary balance is estimated for each country based on assumptions about "long term" rates of growth and interest rates. The estimated structural primary balance ensures that the public debt will be sustainable; that is, that the ratio of debt to GDP will remain constant over time. In the second step, the observed primary balance in 2000 is decomposed into its temporary and structural components. The temporary component of the primary balance is defined as those net revenues attributable to the business cycle and commodity fluctuations.[23] Finally, the third step calculates the "required adjustment" over the medium term to achieve debt sustainability. This adjustment is calculated by subtracting the *actual* structural primary balance in 2000 from the *sustainable structural* primary balance.

From the sole perspective of a country's capacity to pay, table 2 shows that out of the sample countries, Brazil and Mexico were on sustainable public debt paths by end-2001. In the case of Brazil, by the end of 2001, the projected (both by the government and by market specialists) primary surpluses of 3.5 percent of GDP from 2001 onwards appeared to be sufficient to maintain the fiscal stance in order.[24] During the same period, Mexico was also moving towards a sustainable path. By end-2000, the required adjustment over the medium-term to achieve debt sustainability was 0.7 percent of GDP, and the gap was projected to almost close by end-2001.

23. For a detailed step-by-step methodology, see Ghezzi et al. (2001).

The rest of the countries in the sample showed less optimistic results. While the Colombian and the Peruvian cases were unclear (namely, there was important uncertainties about the evolution of the fiscal stance), the cases of Ecuador and Venezuela were rather worrisome. Both countries required significant adjustment in the structural primary balance over the medium-term to achieve debt sustainability (2.1 percent for Ecuador and 3.7 for Venezuela).[25] By end-2001, neither country, however, showed progress toward achieving such an adjustment.[26]

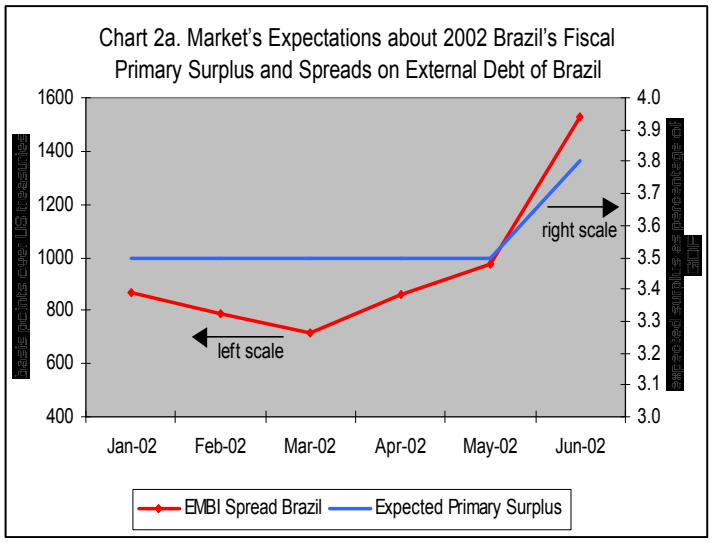
As discussed in section II, analyses of debt sustainability solely based on a country's capacity to pay are incomplete and insufficient to assess whether, indeed, a country is "free of debt problems." Also as discussed in section II, Brazil is a case in point. While in mid-2002, Brazil continued to maintain primary fiscal surpluses at levels equal or above those necessary to achieve a sustainable debt path (from the perspective of its capacity to pay), the markets lost confidence about the *willingness of* future governments to maintain the required fiscal primary surplus and/*or* to transfer the resources from those surpluses toward servicing the debt. Chart 2a compares the evolution of markets' forecasts for 2002 Brazil's fiscal primary surpluses with that of the spread on Brazil's sovereign bonds. Clearly, one could not blame the sharp increase in spreads on the fiscal stance, as forecasts about the primary surplus for 2002 signaled an improvement of the fiscal stance during the current government. Chart 2b compares the spreads with electoral poll results. As the probability of an electoral win for Mr. da Silva increased, the spreads increased. Thus, the high spreads for Brazil in mid-2002 were not driven by expectations of the current government deviating from a stability path but by fears about a "change of course" of a potential future government.

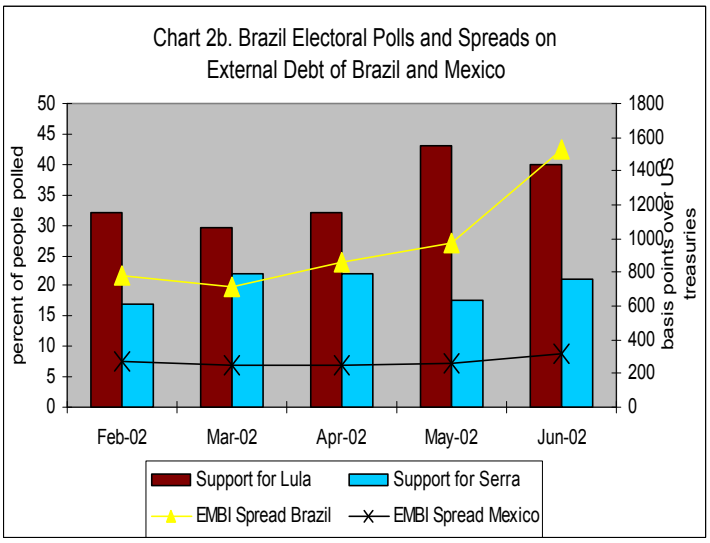
As a benchmark, the evolution of Mexico's bond spreads is also presented in chart 2b. From the perspective of both its "capacity to pay" (table 2) and markets' perception about Mexico's creditworthiness (chart 2b), Mexico did not face a "debt problem" as of mid-2002.

---

24. By June 2002, market participants revised *upwards* the expected primary fiscal surplus for the entire 2002.

25. Calculations for Ecuador presented in table 2 differ somewhat from those in Ghezzi et al. (2001) as I assume lower long-term oil prices than Ghezzi.





Sources: Bloomberg, Datafolha, Deutsche Bank.

This experience shows that the "credibility" of sustained fiscal balances remains extremely fragile in Latin America. While this is not the place to elaborate further on this issue, the lesson that I derive is that additional research is needed in order to determine whether a country is on a sustainable path. If the "required fiscal surplus" for debt sustainability is "too high" it may lose credibility in the presence of adverse shocks, including political uncertainties.

Whether Brazil will be forced to adjust its fiscal stance considerably was an unknown at the time of writing. But with sources of finance curtailed, a potential adjustment may induce certain groups to call for an increase in import tariffs. This indeed happened in Chile at the end of June 2002, when this country's businessmen leaders asked their government for the "suspension" of Chile's participation in Mercosur. Fear of contagion and loss of market credibility were explicitly stated as the reasons for this request. In sum, based on estimates about countries' capacity to service their debt on a sustainable basis and markets' perceptions about countries' creditworthiness, by mid-2002, only Mexico (out the seven countries sampled[27]) could contribute to a stable free trade area. By comparing these results with those from the studies surveyed in this paper, it is evident that there is agreement with respect to two countries: Mexico is "ready" (in Schott's terminology) to both join a free trade area and to contribute to its sustainability. By contrast, Ecuador is far from being a good candidate. Major discrepancies, however, arise with

26. While data on Venezuela is not available, indicators suggest that fiscal conditions have deteriorated in 2001.

respect to Argentina and Venezuela. In Schott (2001), these countries earn high rankings (position 7 for Argentina and position 10 for Venezuela out of 32). This contrasts severely with my findings. From the perspective of debt sustainability, both Argentina and Venezuela are far from being in a position where they could succeed in a free trade agreement on a sustainable basis. Because the WEF study does not incorporate market perceptions' about a country's creditworthiness, Brazil gets a high score in their assessment.

Are Exchange Rate Arrangements in the LAC Region Compatible with a Free Trade Area?

Table 3 presents the exchange rate arrangements in the Americas in mid-2001. There are two central features of these exchange rate systems. First, as the table shows, the variety of exchange rate systems is very large including everything from flexible exchange rates, such as those of Chile and Mexico, to the extreme case of fixity? dollarization, such as Ecuador and Panama. Second, most countries in LAC have not kept a given exchange rate arrangement for a significantly long period of time (say, over a decade). A stylized fact in the region is that not only exchange rates but also exchange rate *systems* are quite volatile. This is illustrated in appendix II.

In section II, I discussed the incompatibility between the exchange rate systems in Mercosur (between Brazil and Argentina) during the period 1999-2001, given (a) the deep economic and financial problems that Argentina faced during that period and (b) the important concentration of trade between these two countries. Here, I will briefly examine whether there exist in the region other forms of exchange rate system incompatibilities that may jeopardize the sustainability of free trade agreements.

27. Argentina is included in the non-performing group.

Table 3 Exchange Rate Arrangements in the Americas

Country	Exchange rate arrangement
Antigua and Barbuda	ECCU - pegged to the US dollar
Argentina	Managed float
Bahamas, The	Fixed against US dollar
Barbados	Fixed against US dollar
Belize	Fixed peg
Bolivia	Managed float
Brazil	Independently floating with inflation targeting
Canada	Independently floating with inflation targeting
Chile	Independently floating with inflation targeting
Colombia	Independently floating with inflation targeting
Costa Rica	Crawling peg
Dominican Republic	Managed float
Dominica	ECCU - pegged to the US dollar
Ecuador	Dollarized
El Salvador	Dollarized
Grenada	ECCU - pegged to the US dollar
Guatemala	Managed float
Guyana	Independently floating with monetary aggregate target
Haiti	Independently floating
Honduras	Exchange rate regime within crawling band
Jamaica	Managed floating with monetary aggregate target
Mexico	Independently floating, monetary aggregate target
Nicaragua	Crawling peg
Panama	Dollarized
Paraguay	Managed floating
Peru	Independently floating with monetary aggregate target.
St. Kitts and Nevis	ECCU - pegged to the US dollar
St. Lucia	ECCU - pegged to the US dollar
St. Vincent and the Grenadines	ECCU - pegged to the US dollar
Suriname	Pegged exchange rate with horizontal band
Trinidad and Tobago	De facto fixed pegged
Uruguay	Managed float
USA	Independently floating
Venezuela	Managed float

ECCU = Eastern Caribbean Currency Union.

Source: IMF.

I start with the Andean Community (AC). In this group, Ecuador stands out for having a very different exchange rate system than its trading partners in the AC: Ecuador has recently dollarized. Some analysts have argued that this may create problems for the sustainability of the AC and for further efforts towards a free trade area involving all countries in the Americas. In what follows I argue that, because of Ecuador's trade patterns with countries in the AC, and with the rest of LAC, most of those fears are unfounded at present.

Table 4 Trade between Regional Trading Partners (percent of total trade)

	Partner Region						
Reporting Region	**FTAA**	**NAFTA**	**Mercosur***	**Andean Community**	**CACM**	**Caricom**	**Rest of world**
Central America	*70.75*	*52.31*	*1.43*	*4.34*	*11.82*	*0.84*	*29.25*
Caricom	*70.35*	*54.74*	*1.30*	*5.55*	*1.61*	*7.14*	*29.65*
Andean Community	*64.87*	*44.80*	*7.72*	*9.95*	*1.90*	*0.50*	*35.13*
NAFTA	*51.96*	*46.90*	*1.84*	*1.63*	*0.89*	*0.69*	*48.04*
Mercosur*	*51.11*	*23.73*	*22.94*	*3.83*	*0.34*	*0.28*	*48.89*

Key: = trade within same region

= most important trading region

* = including Chile.

Source: IMF, *Direction of Trade Statistics* (2001).

Table 4 shows trade between regional trading partners (as percentage of total trade). Trade between countries in the AC is very small (less than 10 percent of total trade of the AC takes place within the Community). In the case of Ecuador, the share of the AC in its total trade is about 15 percent and the share of Ecuador in each individual partner in the AC in no case reaches more than 10 percent. Indeed, the United States is Ecuador's major trading partner (see appendix III).

Another important feature of trade in the AC is that the share of commodities in exports is extremely high in all countries, with Ecuador displaying the highest ratio in the region: 90 percent (see chart 3). During the last decade, only Bolivia, among Andean countries, has managed to significantly reduce this ratio. As a result, this trade area, in general, and Ecuador in particular, is very sensitive to commodity shocks and the business cycles of the partner countries tend to move together.

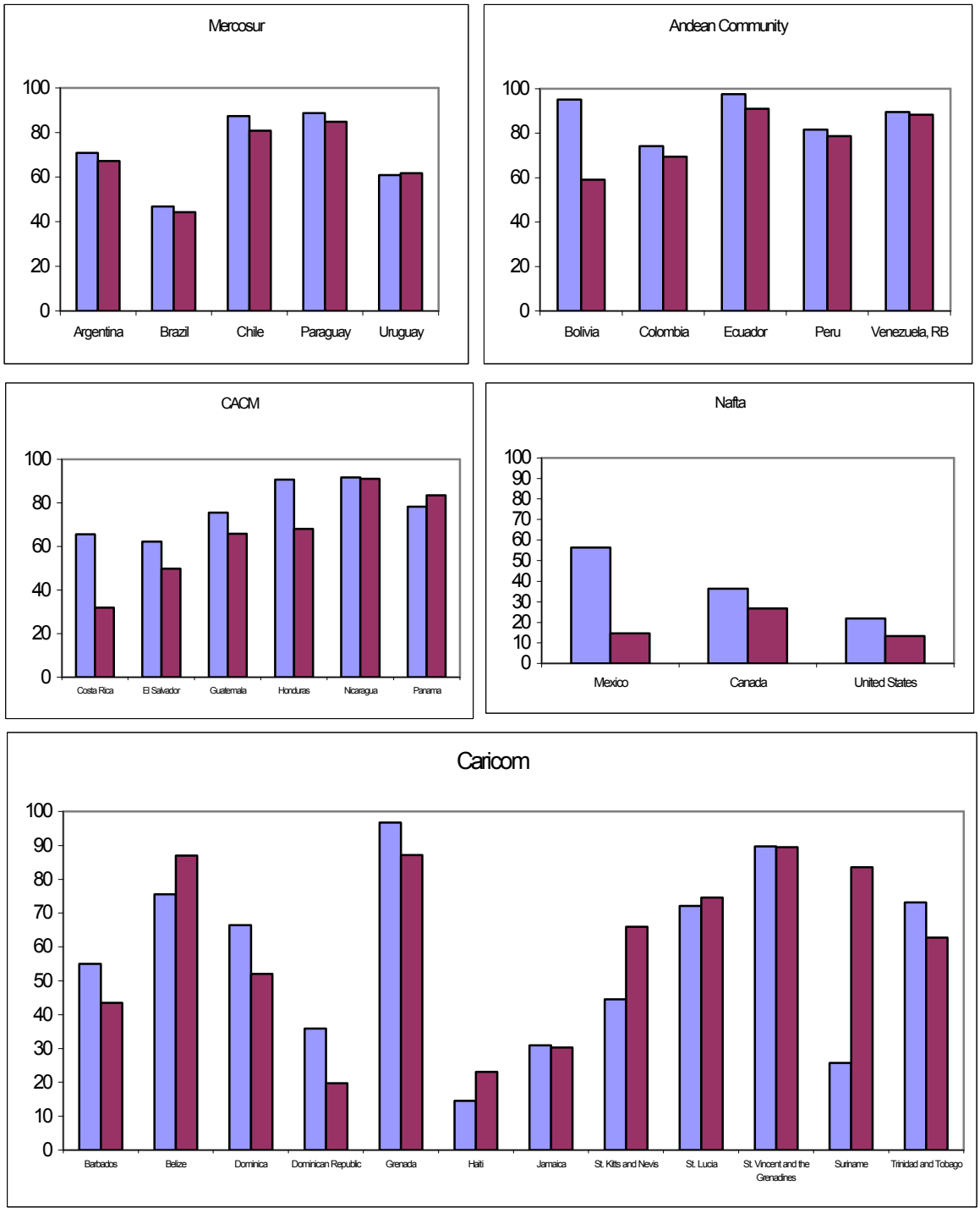
The trade characteristics of Ecuador described above minimize two potential forms of risk to the stability of a free trade area. The first potential risk arises from "common adverse external shocks" (such as a terms of trade shock) impinging on the AC. Facing an adverse shock, currencies in the AC, other than Ecuador, would tend to depreciate.[28] This depreciation of currencies in the AC would reduce the competitiveness of Ecuador's goods and services that compete internationally with similar products exported by AC countries. While in theory, this

28. With the exception of Ecuador, all the other countries in the AC maintain a floating exchange rate regime.

effect could be important, it is not in reality due to the high participation of petroleum and other commodities in Ecuador's exports. This feature implies that a depreciated currency of a partner country within the AC—or for that matter within a free trade area encompassing all countries in LAC— will not have a significant effect on Ecuador's revenues from exports.

Chart 3

Commodity Exports as a Percentage of Total By Trade Area



Source: World Bank, WDI 2001

* Or closest year available

A second risk arises from the potential contagion effects from one country to another through trade links. The argument is that if a country enters a recession, the corresponding decrease in aggregate demand would hurt exports from partner countries. Once again, this potentially important risk to the stability of the AC is not relevant because of the very small percentage of intra-community trade. Going back to the case of Ecuador, while Colombia is Ecuador's most important trading partner within the AC, its share only reaches 8 percent of total trade. To be blunt, significant differences in exchange rate systems within the AC are not relevant to the stability of the trade agreement because trade within the community is very limited.[29] This, of course, does not speak very favorably about the overall relevance of the AC.

My conclusion is, therefore, that as long as Ecuador's exports continue to be concentrated in commodities with its overall trade patterns oriented more towards industrial countries rather than LAC, its choice of exchange rate system will not create a threat to the stability of a trade area. It is interesting to note, however, that if the proposed FTAA significantly increases trade among LAC countries and also contributes to diversifying the basket of exports, dollarization in Ecuador may actually become an issue, similar to that faced by Mercosur in 1999-2001.[30]

Turning to the Central America Common Market (CACM), it is interesting to note that the trade area shares some similarities with the AC. First, the intra-area trade is very small: 12 percent (see table 4). Second, with the exception of Costa Rica, the dependence on commodity exports is very large (over 50 percent). Third, the two dollarized economies in the trade area, Panama and El Salvador largely trade with the United States and with "the rest of the world." However, a significant difference between the AC and the CACM is that the latter is much more "open" in terms of the ratio of exports plus imports to GDP. While, by 1999, this ratio reached about 85 percent in the CACM, the ratio was only around 40 percent in the AC. Another important difference with AC is that several countries within CACM compete with each other (and with Mexico) in the "maquila sector" (largely the textile industry).

Largely because of the small size of these economies and the small proportion of intra-trade, no incompatibilities can be found between the different exchange rate regimes in CACM that could pose a threat to the stability of a trade agreement. None of the countries in this group can gain much by raising tariffs to a partner in CACM and even less to a partner within an FTAA.

29. This conclusion also applies to a trade agreement with other LAC countries as trade between the AC and the rest of LAC is also limited.

30. This problem would arise if, as a result of trade liberalization, Ecuador's trade with a few LAC countries increases significantly. In that situation, a "bad economic outcome" in Ecuador leading to a loss

Similarly, the size of individual countries within the Caribbean Common Market (Caricom) reduces the importance of the choice of exchange rate regime for the sustainability of trade agreements.[31] The coexistence of a group of countries sharing the same currency with a single Central Bank with countries that have chosen a more flexible exchange rate arrangement does not generate incompatibilities that may threaten the FTAA.

Finally, I now turn to examine NAFTA. Based on the success of the trade arrangement between Mexico and the United States, a number of analysts have argued that Mexico could benefit even further from dollarizing its economy. Instead, I would argue that NAFTA has worked *precisely* because Mexico has followed a flexible exchange rate system.

Interestingly enough, NAFTA shares an important feature with Mercosur: as in the case of Mercosur, partners within NAFTA trade significantly among themselves, albeit with different orders of magnitude.[32] This implies that an adverse economic outcome in the United States hurts Mexico through reduced exports or a decrease in capital inflows.[33] As discussed above, the same is true in Mercosur: a recession in Brazil hurts Argentina and conversely.

The key difference between the two systems, however, is that NAFTA has avoided "stresses" similar to those in Mercosur partly by maintaining a flexible exchange rate system since 1995.[34] The flexibility of the exchange rate implies that Mexico has a tool to improve its competitiveness in the face of an adverse shock. If US consumers and investors decrease their demand for Mexican products, or if international investors reverse financial inflow to Mexico, the country can improve its competitiveness through a depreciated exchange rate. This is a more efficient and effective tool to improve Mexico's trade balance with the United States than increasing tariffs since Mexico's chosen motor of growth—trade integration—does not need to be disturbed by temporary fluctuations in the US business cycle or by sudden reversals of capital inflows.[35] The exchange rate arrangements create an incentive for the sustainability of free trade areas.[36]

---

in competitiveness relative to its trading partners may generate pressures for the Ecuadorian authorities to increase tariffs (since the exchange rate cannot move to offset the loss in competitiveness).

31. Notice that I am not discussing about the "appropriateness" of the exchange rate system for economic stability. I am just dealing with the issue as to whether a certain choice of exchange rate regime could create incentives to deviate from a free trade area.

32. As discussed above, none of the other trade agreements share this feature.

33. The converse is not necessarily true for the United States given the relative economic size of this economy.

34. The absence of a debt problem in Mexico, discussed above, has also contributed to the stability of NAFTA.

35. In spite of the US recession in 2001, Mexico did not need to depreciate its currency because of the sustained foreign direct investment—a by-product of NAFTA—towards that country.

36. Of course, the relative size of the partners matters significantly. While an adverse shock in the United States would, most likely, have a severe effect on Mexico, the converse is not true. The sustainability of the

These brief remarks lead me to conclude that, currently, there are few incompatibilities between exchange rate systems and a sustainable free trade area in the Americas. With a low probability, dollarization in Ecuador could become a problem if the free trade area were to result in a concentration of trade with a few partners in LAC. For the rest of the small dollarized countries in the region, the sheer small size of the trade with one another makes their choice of exchange rate systems less relevant for the stability of a potential FTAA.

IV. CONCLUDING REMARKS

This paper has focused on identifying preconditions that would ensure the *sustainability* of a free trade agreement in the Americas. The issue can be bluntly put as follows: even if negotiations for an FTAA were to be finalized by 2005 what guarantees that such an arrangement would be permanent? After all, the LAC region is full of experiments of trade negotiations, that after a short period of enthusiasm were eventually either abandoned or given a very low priority in the policy agenda.

The paper argues that the macro, micro, and political conditions advanced in the literature to measure a country's ability to compete internationally, while necessary, are not sufficient to ensure the success and permanence of trade agreements. Instead, two additional *financial conditions* are needed. The first is that each partner in the free trade area needs to have sustainable public debts as determined by the achievement of *credible and sustainable* structural fiscal balances. The second is that exchange rate regimes across trading partners should be *compatible* in the sense that adverse shocks in one country do not generate a policy dilemma in other partners between abandoning their exchange rate system or the free trade area.

A preliminary analysis of the evidence in the LAC region shows the importance of these two preconditions. An analysis of debt sustainability, regarding countries' *capacity* to pay as well as *markets' perceptions about governments' willingness to service their obligations,* reveals that a number of countries in the region need to deal with potential solvency problems before reaching the status of *credible partners* in a regional trade arrangement. While Argentina is already deemed as insolvent, countries such as Ecuador and Venezuela rank high on the list of countries where the issue of debt sustainability can become a serious problem. Not resolving this issue before reaching a regional trade agreement can threaten its stability. An interesting case is Brazil, where, by mid-2002, markets lost credibility about the *willingness* of a prospective *future* government to continue with the fiscal adjustment needed for debt sustainability. This in spite the

---

trade agreement, therefore, relies significantly on the capacity of Mexico to conduct policy actions that "shield" the country against adverse shocks originated in its major trading partner.

fact that exercises of debt sustainability, from the perspective of Brazil's capacity to pay, show that the *current* government has entered a stability path.

The examination of the *compatibility* of exchange rate systems across trading partners is also very revealing. Part of the success of NAFTA since the late 1990s and the "impasse" of Mercosur during the period 1999-2001, had to do with the choices of exchange rate regimes. In both trade areas, the share of trade between partners is very high, and in NAFTA, this includes significant financial transactions. This implies that economic and financial developments in one partner can severely affect the others. While Mexico was able to use the flexibility of the exchange rate to improve competitiveness following the sharp decline of portfolio flows from US investors into Mexico following the Asian and Russian crises, Argentina had no mechanisms to deal with an adverse shock from Brazil (such as a depreciation of the Real in 1999). From this perspective, the recent move of Argentina towards a more flexible exchange rate system is good news for a sustainable free trade area.

Does this mean that flexible exchange systems are needed *in all countries* for the success of free trade areas in the region? Not necessarily, smaller countries with small trade dependence on individual partners can afford to have a fixed exchange rate system. That is the case in CACM and Caricom, where a variety of very different exchange rate arrangements coexist (including dollarized countries) without threatening the stability of the trade agreements. For a free trade area including all countries in the Americas to be successful, it is necessary that the small countries in the area with less flexible exchange rate arrangement maintain a diversified partnership.

REFERENCES

De Grauwe, Paul, *The Economics of Monetary Integration*, Oxford University Press, Great Britain, 1997.

Fernandez-Arias, Eduardo, Ugo Paniza and Ernesto Stein, *Trade Agreements, Exchange Rate Disagreements,* Background paper for the Seminar, "Looking Beyond Our Borders: Opportunities and Challenges of the New Regionalism", Inter-American Development Bank, Washington, DC March, 2002.

Ghezzi, Piero et al, *Public Debt Sustainability in Select Emerging Markets*, Deutsche Bank, April 2001.

Grinspun, Ricardo and Robert Kreklewich, "Institutions, Power Relations, and Unequal Integration in the Americas: NAFTA as Deficient Institutionality" in *Economic Integration in NAFTA and the US*, edited by Kirsten Appendini and Sven Bislev, St. Martin's Press, New York, 1999.

Grubel, Herbert, *The Case for the Amero: The Economics and Politics of a North American Monetary Union*, Critical Issues, Simon Fraser Institute, Vancouver, 1999.

Hinojosa, Raul, et al, *The US Employment Impacts of North American Integration After NAFTA: A Partial Equilibrium Approach*, University of California at Los Angeles, Los Angeles, 2000.

Hufbauer, Gary and Jeffrey Schott, *Western Hemisphere Economic Integration*, Institute for International Economics, Washington, DC, 1994.

Iglesias, Enrique, " Twelve Lessons from Five Decades of Regional Integration in Latin American and the Caribbean", in *Integration and Trade*, Inter-American Development Bank, April 2001.

IMF, *World Economic Outlook: The Global Economy After September 11*, Washington DC. December 2001.

INTAL, *Mercosur 2000-2001*, Inter-American Development Bank, December 2001.

Lora, Eduardo, "Las Reformas Estructurales en America Latina: Que se ha Reformado y como Medirlo", IADB, November, 2001.

Pastor, Robert, *Toward a North American Community: Lessons from the Old World for the New*, Institute for International Economics, Washington, DC, August 2001.

Rojas-Suarez, Liliana, "Los procesos de Dolarizacion de America Latina" in *La Dolarizacion en Ecuador: Efectos sobre el Comercio Andino*, Comunidad Andina, Lima, Peru, March 2001.

Schott, Jeffrey, *Prospects for Free Trade in the Americas*, Institute for International Economics, Washington, DC, August, 2001.

Talvi, Ernesto and Carlos Vegh, *Fiscal Policy Sustainability: A Basic Framework*, mimeo, Inter-American Development Bank, Washington, DC, 1998.

Weintraub, Sidney, *NAFTA at Three: A Progress Report*, Center for Strategic and International Studies, Washington, DC, 1997.

World Economic Forum (2001). *The Latin American Competitiveness Report 2001-2002.*

Appendix I
Macroeconomic Stability Indices

WEF (2001) Macroeconomic Stability Subindex*		Schott (2001) Macroeconomic Indicator*	
Panama	1	Chile	1
Trinidad & Tobago	2	Paraguay	1
Chile	3	Dominican Republic	1
Costa Rica	4	Trinidad & Tobago	1
Venezuela	5	Panama	1
Mexico	6	Mexico	6
El Salvador	7	Venezuela, RB	6
Honduras	8	Costa Rica	6
Paraguay	9	El Salvador	6
Brazil	10	Uruguay	10
Ecuador	11	Peru	10
Dominican Republic	12	Jamaica	10
Jamaica	13	Honduras	10
Guatemala	14	Guatemala	14
Colombia	15	Argentina	15
Nicaragua	16	Bolivia	15
Uruguay	17	Colombia	17
Peru	18	Nicaragua	18
Argentina	19	Brazil	19
Bolivia	20	Ecuador	20

* The rankings have been adjusted to ease comparisons.

Sources: World Economic Forum (2001); Schott (2001).

Appendix II
Evolution of Exchange Rate Systems* in Selected Latin American Countries 1970-2000

	1970-74	1975-79	1980-94	1985-89	1990-94	1995-99	2000-02
Argentina	peg	crawling peg	adjustable peg	managed float	peg; currency board	currency board	currency board; dual exchange rates; manged float
Bolivia	peg	peg	peg	float	float	float; managed float	managed float
Brazil	exchange rate indexed to inflation (real exchange rate targeting)	exchange rate indexed to inflation (real exchange rate targeting)	mini devaluations based on price differentials	mini devaluations based on price differentials	managed peg	band; float	float
Chile	peg	crawling peg; peg	peg; crawling peg	crawling peg	peg; crawling peg	band; crawling band; float	float
Colombia	crawling peg	crawling peg	crawling peg	crawling peg	crawling peg exchange rate band	fixed band; crawling band	float
Ecuador	dual exchange rate system	dual exchange rate system	multiple exchange rate markets	multiple exchange rate markets	dual exchange rate system	dual exchange rate system; dollarization	dollarization
Mexico	peg	peg	peg; managed peg	managed peg	crawling peg; float	float	float
Peru	peg	peg	peg	peg	float	float	float
Venezuela	peg	peg	peg	multiple exchange rate markets	managed peg	peg; bands; crawling band	crawling band, float

Sources: IMF: Exchange Arrangements and Exchange Restrictions (various issues); Jeffry Frieden and Ernesto Stein, eds. (2001): The Currency Game Exchange Rate Politics in Latin America.

* System reported is the predominant during the period considered.

Appendix III Trade with Partner (percent of total trade)

Partner Country

Reporting Country	*FTAA*	**Nafta**	Canada	Mexico	US	**Mercosur**	Argentina	Brazil	Chile	Paraguay	Uruguay	**Andean Community**	Bolivia	Colombia	Ecuador	Peru	Venezuela	**CACM**	Costa Rica	El Salvador	Guatemala
Central America	***70.75***	***52.31***				***1.43***						***4.34***						***11.82***			
El Salvador	*78.85*	**54.25**	1.57	3.81	48.86	**1.03**	0.17	0.61	0.24	0.00	0.00	**2.83**	0.00	0.36	1.42	0.08	0.97	**19.91**	3.60	0.00	10.06
Honduras	*76.38*	**66.40**	0.61	2.61	63.18	**0.60**	0.07	0.39	0.13	0.00	0.00	**1.10**	0.00	0.48	0.12	0.06	0.45	**7.36**	0.60	1.78	0.97
Guatemala	*74.09*	**52.93**	1.88	6.62	44.43	**1.64**	0.39	0.83	0.39	0.00	0.03	**4.10**	0.00	0.80	0.38	0.27	2.65	**14.35**	3.81	7.41	0.00
Nicaragua	*70.94*	**42.50**	1.85	4.84	35.81	**0.87**	0.21	0.38	0.25	0.00	0.02	**7.03**	0.01	0.23	0.27	0.08	6.45	**19.61**	8.54	0.00	5.87
Panama	*65.89*	**40.27**	1.04	3.78	35.45	**2.05**	0.45	0.92	0.67	0.00	0.02	**14.70**	0.02	2.99	5.95	0.29	5.45	**8.09**	3.83	0.90	2.00
Costa Rica	*61.82*	**47.19**	1.31	3.47	42.42	**1.95**	0.38	1.14	0.41	0.00	0.02	**3.87**	0.00	1.02	0.14	0.12	2.59	**8.17**	0.00	1.94	2.71
Caricom	***70.35***	***54.74***				***1.30***						***5.55***						***1.61***			
Dominican Republic	*85.45*	**73.65**	0.54	3.11	70.00	**1.04**	0.17	0.67	0.14	0.00	0.06	**7.42**	0.00	0.54	0.08	0.07	6.72	**2.01**	0.31	0.09	0.20
Haiti	*81.64*	**63.51**	1.60	0.51	61.40	**3.10**	1.16	1.29	0.52	0.00	0.13	**2.14**	0.00	1.80	0.03	0.30	0.00	**1.56**	0.00	0.04	1.08
Trinidad & Tobago	*79.01*	**44.84**	1.82	1.65	41.37	**1.51**	0.14	1.25	0.07	0.00	0.04	**13.08**	0.00	3.74	0.21	0.17	8.96	**2.64**	0.33	0.52	0.64
Grenada	*75.18*	**44.36**	1.50	0.00	42.86	**3.65**	0.45	3.12	0.04	0.00	0.04	**0.22**	0.00	0.19	0.02	0.01	0.00	**0.07**	0.00	0.01	0.06
St. Kitts & Nevis	*74.36*	**57.39**	4.37	0.00	53.02	**0.16**	0.00	0.07	0.09	0.00	0.00	**0.41**	0.00	0.41	0.00	0.00	0.00	**0.00**	0.00	0.00	0.00
Dominica	*72.41*	**33.08**	3.13	0.56	29.39	**0.56**	0.01	0.52	0.04	0.00	0.00	**1.71**	0.00	0.31	0.04	0.00	1.36	**1.46**	0.53	0.00	0.46
St. Vincent & Gren.	*70.14*	**32.39**	2.37	0.28	29.74	**0.82**	0.05	0.76	0.01	0.00	0.00	**1.06**	0.00	0.30	0.00	0.00	0.76	**1.61**	0.18	0.01	0.25
Belize	*70.07*	**59.72**	1.98	6.83	50.92	**0.92**	0.24	0.67	0.01	0.00	0.00	**1.38**	0.00	0.12	0.02	0.03	1.20	**4.35**	0.27	0.93	1.91
Jamaica	*69.42*	**52.40**	5.15	3.60	43.66	**1.37**	0.12	1.05	0.12	0.00	0.07	**3.38**	0.00	0.48	0.02	0.07	2.81	**1.62**	0.48	0.02	0.22
St. Lucia	*69.23*	**33.71**	1.85	0.00	31.86	**13.36**	0.07	13.13	0.15	0.00	0.00	**0.48**	0.00	0.48	0.00	0.01	0.00	**0.00**	0.00	0.00	0.00
Barbados	*67.14*	**38.67**	3.29	0.23	35.15	**2.39**	0.10	2.08	0.21	0.00	0.00	**0.48**	0.01	0.20	0.07	0.01	0.20	**1.30**	0.31	0.02	0.65
Guyana	*53.99*	**38.88**	11.84	0.00	27.04	**0.50**	0.02	0.43	0.03	0.00	0.01	**0.59**	0.00	0.24	0.33	0.02	0.00	**0.13**	0.00	0.00	0.00
Suriname	*44.88*	**31.55**	4.17	0.00	27.38	**0.94**	0.12	0.78	0.02	0.00	0.03	**0.44**	0.00	0.37	0.05	0.02	0.00	**0.23**	0.08	0.00	0.14
Bahamas, The	*35.55*	**32.71**	0.62	1.13	30.96	**0.74**	0.02	0.67	0.05	0.00	0.01	**1.05**	0.00	0.64	0.01	0.41	0.00	**0.28**	0.00	0.23	0.01
Antigua & Barbuda	*12.59*	**9.78**	0.86	0.00	8.92	**0.07**	0.00	0.05	0.00	0.00	0.02	**0.04**	0.00	0.02	0.01	0.00	0.00	**0.00**	0.00	0.00	0.00
Andean Community	***64.87***	***44.80***				***7.72***						***9.95***						***1.90***			
Bolivia	*76.96*	**18.63**	0.73	1.54	16.36	**40.74**	13.31	19.54	7.54	0.21	0.13	**17.49**	0.00	8.26	3.53	5.58	0.12	**0.08**	0.03	0.00	0.01
Colombia	*72.75*	**47.74**	1.79	3.15	42.80	**5.94**	0.82	3.20	1.81	0.02	0.09	**15.34**	0.99	0.00	3.16	2.09	9.10	**2.05**	0.54	0.10	0.31
Ecuador	*66.24*	**38.51**	1.62	2.03	34.87	**8.30**	2.23	1.72	4.17	0.05	0.12	**15.57**	1.10	8.32	0.00	2.42	3.73	**3.54**	0.15	0.58	0.38
Venezuela, RB	*62.46*	**49.32**	1.41	1.86	46.05	**5.48**	0.56	3.90	0.86	0.02	0.14	**5.96**	0.01	3.90	0.69	1.36	0.00	**1.70**	0.68	0.13	0.50
Peru	*56.80*	**33.59**	2.20	2.56	28.83	**11.70**	1.81	3.87	5.59	0.09	0.33	**9.46**	1.01	3.52	1.58	0.00	3.35	**1.59**	0.12	0.04	0.17
Nafta	***51.96***	***46.90***				***1.84***						***1.63***						***0.89***			
Mexico	*85.35*	**82.53**	2.17	0.00	80.36	**1.31**	0.16	0.70	0.39	0.00	0.06	**0.66**	0.01	0.21	0.05	0.11	0.27	**0.60**	0.14	0.07	0.18
Canada	*79.28*	**78.01**	0.00	1.84	76.17	**0.57**	0.08	0.33	0.13	0.00	0.02	**0.43**	0.00	0.08	0.03	0.05	0.27	**0.13**	0.04	0.02	0.04
United States	*38.70*	**32.22**	20.09	12.13	0.00	**2.28**	0.40	1.47	0.35	0.02	0.04	**2.13**	0.02	0.54	0.17	0.19	1.20	**1.15**	0.31	0.18	0.23
Mercosur	***51.11***	***23.73***				***22.94***						***3.83***						***0.34***			
Paraguay	*74.29*	**13.29**	0.13	0.29	12.86	**60.04**	24.37	30.44	2.73	0.00	2.50	**0.94**	0.14	0.13	0.11	0.29	0.27	**0.01**	0.00	0.00	0.00
Uruguay	*63.34*	**12.86**	1.45	2.19	9.22	**46.10**	21.64	20.77	2.00	1.69	0.00	**3.76**	0.06	0.25	0.22	0.36	2.87	**0.26**	0.06	0.01	0.05
Argentina	*57.68*	**17.55**	0.80	1.08	15.67	**37.21**	0.00	26.30	6.38	1.89	2.64	**2.55**	0.79	0.37	0.42	0.48	0.50	**0.25**	0.10	0.02	0.07
Chile	*48.77*	**24.56**	2.11	4.07	18.38	**17.29**	10.06	6.55	0.00	0.33	0.35	**6.28**	0.56	1.27	1.16	1.96	1.33	**0.49**	0.15	0.05	0.11
Brazil	*47.49*	**27.10**	1.49	2.15	23.46	**15.88**	11.66	0.00	1.96	1.03	1.22	**3.76**	0.44	0.82	0.13	0.50	1.88	**0.35**	0.13	0.04	0.07

- trade within same region

- major trading partner

Source: IMF: Direction of Trade December 2001

Appendix III (continued)

Partner Country

Reporting Country	Honduras	Nicaragua	Panama	**Caricom**	Antigua & Barbuda	The Bahamas	Barbados	Belize	Dominica	Dominican Republic	Grenada	Guyana	Haiti	Jamaica	St. Kitts & Nevis	St. Lucia	St. Vincent & Gren.	Suriname	Trinidad & Tobago	*Rest of world*
Central America				***0.84***																***29.25***
El Salvador	3.78	1.99	0.47	**0.83**	0.00	0.15	0.00	0.07	0.00	0.19	0.00	0.00	0.01	0.01	0.00	0.00	0.00	0.00	0.40	*21.15*
Honduras	0.00	3.63	0.37	**0.92**	0.00	0.00	0.03	0.05	0.00	0.29	0.00	0.00	0.00	0.08	0.00	0.00	0.01	0.00	0.45	*23.62*
Guatemala	0.92	1.43	0.77	**1.08**	0.00	0.00	0.07	0.11	0.01	0.30	0.00	0.00	0.14	0.09	0.00	0.00	0.00	0.01	0.35	*25.91*
Nicaragua	4.25	0.00	0.95	**0.93**	0.00	0.02	0.00	0.01	0.00	0.24	0.00	0.04	0.09	0.00	0.00	0.00	0.00	0.00	0.54	*29.06*
Panama	0.77	0.58	0.00	**0.77**	0.00	0.04	0.00	0.00	0.00	0.38	0.00	0.01	0.09	0.11	0.00	0.00	0.00	0.00	0.14	*34.11*
Costa Rica	1.01	1.44	1.07	**0.64**	0.00	0.00	0.02	0.01	0.01	0.33	0.00	0.00	0.00	0.14	0.00	0.00	0.00	0.00	0.13	*38.18*
Caricom				***7.14***																***29.65***
Dominican Republic	0.15	0.04	1.21	**1.33**	0.00	0.01	0.02	0.01	0.01	0.00	0.00	0.00	0.80	0.10	0.00	0.00	0.00	0.01	0.35	*14.55*
Haiti	0.00	0.18	0.26	**11.34**	0.00	0.01	0.06	0.00	0.00	9.38	0.00	0.00	0.00	0.08	0.00	0.00	0.00	0.03	1.77	*18.36*
Trinidad & Tobago	0.72	0.25	0.20	**16.94**	0.27	0.42	3.36	0.14	0.32	1.45	0.71	1.45	0.44	5.10	0.36	0.83	0.57	1.52	0.00	*20.99*
Grenada	0.00	0.00	0.00	**26.88**	0.80	0.06	4.07	0.00	0.73	0.26	0.00	1.06	0.00	0.88	0.08	1.82	0.81	0.14	16.16	*24.82*
St. Kitts & Nevis	0.00	0.00	0.00	**16.40**	0.00	0.01	3.65	0.00	1.14	0.22	0.09	0.41	0.00	0.75	0.00	0.00	1.20	0.00	8.91	*25.64*
Dominica	0.06	0.00	0.40	**35.60**	2.31	0.09	3.58	0.01	0.00	0.69	1.00	2.52	0.01	7.21	1.27	1.98	1.39	0.24	13.29	*27.59*
St. Vincent and Gren.	0.63	0.00	0.54	**34.26**	1.43	0.03	5.39	0.05	1.18	0.28	0.96	1.86	0.01	1.29	1.24	2.15	0.00	0.01	18.39	*29.86*
Belize	0.76	0.03	0.44	**3.70**	0.05	0.04	0.55	0.00	0.06	0.02	0.00	0.12	0.00	1.40	0.00	0.02	0.00	0.00	1.44	*29.93*
Jamaica	0.18	0.00	0.72	**10.65**	0.06	0.11	0.54	0.21	0.35	0.36	0.05	0.81	0.02	0.20	0.04	0.06	0.07	0.17	7.59	*30.58*
St. Lucia	0.00	0.00	0.00	**21.68**	0.00	0.01	5.43	0.03	0.92	0.20	1.19	0.58	0.01	0.66	0.00	0.00	1.15	0.05	11.47	*30.77*
Barbados	0.24	0.00	0.08	**24.29**	0.71	0.23	0.00	0.26	0.60	0.28	0.86	1.40	0.08	2.24	0.67	1.86	0.98	0.82	13.31	*32.86*
Guyana	0.00	0.08	0.05	**13.89**	0.49	0.00	1.38	0.07	0.44	0.03	0.22	0.00	0.00	2.82	0.08	0.20	0.31	0.75	7.11	*46.01*
Suriname	0.00	0.00	0.00	**11.72**	0.04	0.01	1.03	0.00	0.05	0.22	0.04	0.87	0.04	0.74	0.00	0.02	0.00	0.00	8.65	*55.12*
Bahamas, The	0.00	0.01	0.04	**0.76**	0.00	0.00	0.06	0.01	0.00	0.03	0.00	0.00	0.01	0.11	0.00	0.00	0.00	0.00	0.54	*64.45*
Antigua & Barbuda	0.00	0.00	0.00	**2.71**	0.00	0.01	0.54	0.02	0.29	0.03	0.12	0.35	0.00	0.19	0.00	0.00	0.19	0.03	0.94	*87.41*
Andean Community				***0.50***																***35.13***
Bolivia	0.00	0.01	0.03	**0.02**	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.01	*23.04*
Colombia	0.16	0.02	0.91	**1.68**	0.00	0.11	0.01	0.00	0.00	0.42	0.00	0.01	0.10	0.10	0.00	0.01	0.00	0.01	0.90	*27.25*
Ecuador	0.05	0.02	2.35	**0.32**	0.00	0.00	0.01	0.00	0.00	0.13	0.00	0.04	0.00	0.01	0.00	0.00	0.00	0.01	0.11	*33.76*
Venezuela, RB	0.07	0.31	0.00	**0.00**	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	*37.54*
Peru	0.03	0.01	1.22	**0.46**	0.00	0.14	0.00	0.02	0.00	0.09	0.00	0.00	0.03	0.03	0.00	0.00	0.00	0.00	0.15	*43.20*
Nafta				***0.69***																***48.04***
Mexico	0.06	0.03	0.12	**0.25**	0.00	0.01	0.00	0.01	0.00	0.15	0.00	0.00	0.00	0.03	0.00	0.00	0.00	0.00	0.03	*14.65*
Canada	0.01	0.01	0.01	**0.15**	0.00	0.01	0.01	0.00	0.00	0.02	0.00	0.03	0.00	0.04	0.00	0.00	0.00	0.01	0.02	*20.72*
United States	0.29	0.05	0.10	**0.92**	0.01	0.07	0.02	0.01	0.00	0.44	0.01	0.02	0.04	0.10	0.01	0.01	0.00	0.01	0.17	*61.30*
Mercosur				***0.28***																***48.89***
Paraguay	0.00	0.00	0.00	**0.01**	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	*25.71*
Uruguay	0.00	0.01	0.14	**0.35**	0.01	0.01	0.00	0.00	0.00	0.14	0.00	0.00	0.03	0.05	0.00	0.00	0.00	0.00	0.11	*36.66*
Argentina	0.01	0.01	0.03	**0.11**	0.00	0.00	0.00	0.00	0.00	0.05	0.00	0.00	0.03	0.01	0.00	0.00	0.00	0.00	0.01	*42.32*
Chile	0.03	0.02	0.12	**0.15**	0.00	0.01	0.01	0.00	0.00	0.09	0.00	0.00	0.02	0.02	0.00	0.00	0.00	0.00	0.01	*51.23*
Brazil	0.03	0.01	0.08	**0.39**	0.00	0.02	0.02	0.00	0.00	0.11	0.01	0.00	0.01	0.04	0.00	0.04	0.00	0.01	0.12	*52.51*