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Chapter III

THE "NEW REGIONALISM" AND NORTH-SOUTH TRADE AGREEMENTS

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Regional economic cooperation occurs in various forms and degrees, and is in general aimed at increasing cross-border linkages and deepening interpenetration of economic activity for the mutual benefit of economies within a geographic region. A distinction is frequently made between policy-induced integration, which is also called regionalism and involves formal economic cooperation arrangements, and market-driven integration, also termed regionalization, which is spurred by regional growth dynamics, the emergence of international production networks and related flows of FDI. As individual developing countries become more vulnerable and lose national policy autonomy in the process of globalization, regional economic cooperation can also be a defensive response in the hope that a regional partnership will soften the impact of global factors and help them to cope better with globalization. From this perspective, regional institutions could also fill gaps in global economic governance structures.

Formal regional cooperation and effective integration interact with each other: formal cooperation can pave the way for the creation of cross-border input-output linkages, while pressure from producers within the region to lower or remove the various barriers to intraregional trade grows as such external linkages intensify. These various demands are likely to be accompanied by the creation of institutions for closer cooperation. The form that such cooperation takes will depend not only on the specific historical, geographical and political circumstances in a region, but also on a fundamental choice of the relative weight given to market forces and State intervention – a choice that also influences economic policies at the national and global levels. Over the past two and half decades these policies have been based on the belief that market liberalization and opening up to international trade and finance would lead to the best possible factor allocation in general, and raise productivity and accelerate technological upgrading in developing countries, in particular. This tendency to give priority to market forces in determining factor allocation is reflected in the rapidly increasing number of regional and bilateral free trade agreements (FTAs) or preferential trade agreements (PTAs) since the early 1990s (fig. 3.1).

> The form of regional cooperation depends on the specific circumstances in a region, and on the relative weight given to market forces and State intervention.

This chapter first discusses the concept of regionalism and how it has grown rapidly since the beginning of the 1990s, a period during which the number of developing countries adhering to multilateral agreements negotiated within the framework of the World Trade Organization (WTO) also increased rapidly. As most regional or bilateral FTAs in recent years have been concluded between a developed and a developing partner, section B examines the implications of such agreements from a development perspective and vis-à-vis WTO agreements. Section C discusses the effects on Mexico's development of the most prominent North-South FTA, the North American Free Trade Agreement (NAFTA) between Canada, Mexico and the United States. Although concluded in a specific geographical context, NAFTA is often perceived as a possible model for other North-South agreements.

A. Regionalism and the proliferation of free trade agreements

The term "regional trade agreement" (RTA)[1], is often used to include PTAs not only between countries belonging to the same geographical region, but also those between countries not geographically contiguous or even nearby.[2] Moreover, traditionally, RTAs involved only reducing or eliminating barriers to trade, but since the beginning of the 1990s such agreements also involve what has come to be called "deep integration", which includes additional elements of harmonizing national policies in line with a reform agenda that favours greater freedom for market forces and reduces options for government intervention. The fact that regional cooperation extends beyond the reduction of trade barriers is not entirely new, because, as discussed in subsequent chapters of this report, regional cooperation has often covered areas such as monetary and financial cooperation or common projects in energy or industrial policy. What is new, is that many of these agreements make the reduction of trade barriers conditional on partners agreeing to liberalize such additional areas as their FDI regime, government procurement, trade in services and competition policy (Shadlen, 2005a). Also new is that most FTAs and RTAs since the early 1990s have involved countries with much larger differences in per capita income and level of development, and that they have been concluded mainly among countries not belonging to the same geographical region (Burfisher, Robinson and Thierfelder, 2003). These two elements characterize the "new regionalism", a term that is somewhat misleading, since in reality it refers to trade agreements that are mostly bilateral and concluded between countries in different regions.

> The tendency to give priority to market forces is reflected in the rapidly increasing number of free trade agreements concluded since the early 1990s.

The trend towards this "new regionalism", as distinct from multilateralism, has grown out of a sense of frustration of some governments at the slow progress in multilateral trade negotiations, and their perception that FTAs can serve as a vehicle for advancing a far-reaching agenda of economic liberalization and harmonization across a broad range of policies, laws and institutions aimed at promoting the internationalization of investment and production. In a way, this "new regionalism" bypasses multilateral institutions and arrangements as governments pursue economic objectives and use instruments for which no agreement could be found at the multilateral level. At the same time, it reflects the tendency to perceive globalization as a process whereby access to markets of the North and attracting FDI from developed-country investors is key to successful integration of developing countries into the world economy.

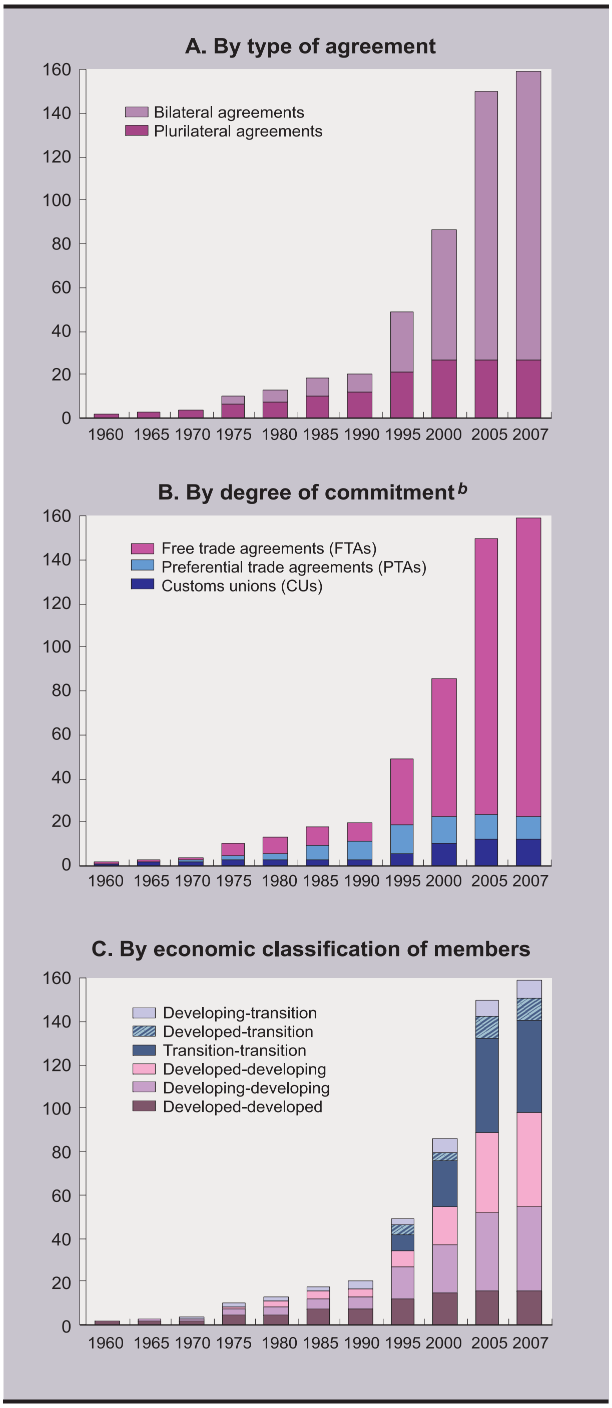
Since the early 1990s, the number of trade agreements has increased rapidly: in 1990, 20 arrangements were notified to the GATT/WTO, increasing to 86 in 2000 and to 159 in 2007.[3] Until the 1990s, plurilateral agreements dominated, but subsequent agreements have been mainly bilateral, and most are FTAs rather than customs unions (figs. 3.1A and B). Typically, bilateral FTAs involve lower levels of commitment to economic integration than multilateral customs unions or common markets, and are concluded between countries from different regions and at different levels of development. Indeed, many of the new pacts have been between developing and developed countries, thus increasing the proportion of treaties between them from 14 per cent of the total number of agreements in 1995 to 27 per cent in 2007 (fig. 3.1C).

The WTO report, *The Future of the WTO*, criticized the proliferation of bilateral and regional trade agreements on the grounds that this has made the most-favoured-nation (MFN) principle the exception rather than the rule, and has led to increased discrimination in world trade (WTO, 2004). However, negotiations of such agreements have continued to progress.

There are several reasons for the rapid growth in the number of trade agreements. One has to do with the fragmentation of States in Central and Eastern Europe and the former Soviet Union, and the dissolution of the Council for Mutual Economic Assistance (COMECON).[4] Previous trade linkages between national or subnational economies that needed few trade arrangements or no arrangement at all – when the parties were constituents of a single State – were replaced by dozens of new agreements between them and with other parties, boosting the number of trade agreements involving transition economies (fig. 3.1C).

Figure 3.1

NUMBER OF PLURILATERAL AND BILATERAL TRADE AGREEMENTS, CUMULATIVE, 1960–2007[a]



Source: UNCTAD secretariat, based on WTO, 2007.

a Data include trade agreements notified to the GATT/WTO at the time they entered into force. Agreements on services and accessions of new members to existing agreements are not included.

b Movements from one kind of agreement to another are taken into account.

On the other hand, the accession of 10 new members to the EU led to the abrogation of 65 trade agreements notified to the WTO, as all the previous bilateral arrangements between them and the EU, as well as agreements with third parties that already had preferential agreements with the EU, came to an end (Crawford and Fiorentino, 2005: 8). As shown by these examples, there is not necessarily a positive correlation between the number of trade agreements and the intensity of economic integration: a single RTA between several countries may result in stronger trade and economic integration than a large number of bilateral agreements between them.

> Certain issues on which no agreement could be found in multilateral trade negotiations have become elements of bilateral FTAs.

Another reason, of greater economic and developmental relevance, is the trend by major developed countries to seek bilateral or regional agreements with developing countries in parallel with ongoing multilateral trade negotiations. The United States has been the most energetic in negotiating FTAs, particularly with developing countries. In 1994 it concluded NAFTA with Canada and Mexico, and in the same year an initiative was launched to achieve a continental FTA "from Alaska to Tierra del Fuego", renewing the Pan-American trade integration project the United States had unsuccessfully championed in the late nineteenth century. However, negotiations reached deadlock on issues such as agricultural subsidies, and the initiative faced growing opposition in several Latin American countries. As a result, and in view of the slow progress in the Doha Round of multilateral trade negotiations, the United States has turned increasingly towards bilateral FTAs. Its position was clearly stated by Zoellick (2003), the United States Trade Representative at the time: "We will not passively accept a veto over America's drive to open markets. We want to encourage reformers who favor free trade. If others do not want to move forward, the United States will move ahead with those who do." Under the Trade Act of 2002 that re-established the "fast-track" trade authority, the United States Government completed bilateral FTAs with 11 other developing countries, in addition to NAFTA, and 5 more agreements are under congressional consideration.[5] It also intends to enter into bilateral trade agreements with all 10 members of ASEAN (McMahon, 2007).[6]

> FTAs tend to reduce the policy space of developing countries to influence the manner of their integration into the global economy.

The EU has also signed various forms of bilateral FTAs with developing countries and economies in transition, although not as many as the United States. Economic partnership agreements (EPAs) are under negotiation with the African, Caribbean and Pacific (ACP) group of countries, aimed at strengthening economic and political relations with many former colonies, and negotiations between the EU and several North African and West Asian countries are intended to culminate in a Euro-Mediterranean Free Trade Area by 2010.[7] It also has preferential Partnership and Cooperation Agreements with South-East European countries, as well as traditional MFN agreements with the Russian Federation and other members of the Commonwealth of Independent States (CIS). In the case of some Eastern European countries, such agreements have prepared the ground for accession to the EU. Apart from agreements with the group of ACP States, the EU has additional bilateral preferential agreements with seven developing economies,[8] and is in negotiations for FTAs with the Southern Common Market (MERCOSUR) and a number of Asian countries.

More recently, Japan has been involved in bilateral trade negotiations with several countries in the Asia-Pacific region, probably in response to competitive pressures resulting from trade agreements they have signed with other developed countries. It has already agreed FTAs with Singapore and Mexico, and is engaged in talks with members of ASEAN and the Republic of Korea. Other developed and developing economies, such as the European Free Trade Association (EFTA), Australia, Chile, China, Mexico, Singapore and

Turkey, have also pursued a strategy of entering into bilateral PTAs with countries from very diverse regions, thereby adding to the proliferation of such agreements.

The present trends towards trade integration, particularly the proliferation of FTAs and PTAs between countries at different levels of development, introduce fundamental changes to the previous paradigm of regional agreements. These earlier agreements were among countries at relatively similar levels of development, which, *inter alia*, sought the establishment of economic and political areas that would maintain or enlarge the policy space of their participants vis-à-vis the rest of the world. The following section examines the specific implications of North-South bilateral agreements in greater detail.

B. Issues relating to North-South free trade agreements, the WTO and policy space

A developing country may be tempted to conclude a bilateral agreement with a developed-country partner because it expects some concessions that are not granted to other countries, particularly better market access for its products. But there are also several potential disadvantages, to a large extent resulting from the fact that certain issues on which developing countries could not agree in multilateral trade negotiations have become elements of bilateral FTAs. These include far-reaching liberalization of foreign investment and government procurement, new rules on certain aspects of competition policy, stricter rules on intellectual property rights, and the incorporation of labour and environmental standards. Moreover, most FTAs oblige developing countries to undertake much broader and deeper liberalization of trade in goods. Some also involve liberalizing services that differs from what is envisaged in the context of WTO agreements and implies greater pressure on developing countries to make liberalization commitments in this area. In addition, while their commitments in the WTO already reduced the policy space that developing countries had at their disposal to influence the manner of their integration into the global economy and the possibility for developing internationally competitive domestic industries, many of the elements of such FTAs reduce that space even further, in some cases very significantly (*TDR 2006*, chap. V, sect. C). These elements are not considered in standard modelling analyses of the impact of trade liberalization, yet they may have lasting effects on the trade and growth potential of the developing-country partners. Some of the major issues surrounding such agreements are discussed in this section.

1. Reciprocity

Because they involve reciprocal commitments, FTAs between developed and developing countries eliminate the special and differential treatment that may be granted to developing countries in the context of other agreements (Crawford and Fiorentino, 2005; Khor, 2007a). For instance, the Lomé Convention (signed in 1975 and renewed four times until 2000) granted the ACP countries preferential access to the EU market without reciprocity. Its successor, the Cotonou Agreement of 2000, extended this non-reciprocal arrangement until the end of 2007, at which time it is to be replaced by EPAs,[9] which would include FTAs based on the principle of reciprocity (Cotonou Agreement, Article 36;[10] EC, 2007). Thus ACP countries will be required to give full access to substantially all EU exports within a reasonable time (Godfrey, 2006). Another example of a formerly non-reciprocal RTA being converted into a reciprocal one is the Central American Free Trade Agreement (CAFTA) with the United States.[11]

One important reason why reciprocity is a major principle underlying FTAs and RTAs, is because such agreements have to comply with GATT Art. XXIV (8)(b), which requires that duties and other restrictive regulations of commerce be "eliminated on substantially all the trade between the constituent territories in products originating in such territories" (WTO, 1994: 522–525). However, so far there is no agreement among WTO members on the meaning of "substantially all the trade", and the issue is under discussion in the context of the Doha Round. Consequently, many agreements exclude from their coverage large and sensitive areas such as agriculture and textiles, which makes it difficult to assess the compatibility of FTAs and RTAs with WTO rules. Recently, in the Doha Round negotiations, there have been proposals to revise or clarify Article XXIV so that it would explicitly allow non-reciprocal relations in FTAs between developed and developing countries.[12]

This is necessary because the reciprocity principle in North-South FTAs places developing countries at a disadvantage vis-à-vis their developed-country partners, as they typically enter into the liberalized trade relationship at a less advanced stage of domestic industrial development, implying lower supply and marketing capacities and less potential for outward foreign investment. In order to comply with the principle of reciprocity, developing countries are forced to cut tariffs from a significantly higher level, especially on industrial products. This makes it difficult for local firms and farmers to compete with imported products, especially when some of these imports remain heavily subsidized by their country of origin, as in the case of agricultural products exported from the EU and the United States. Most importantly, insistence on reciprocity formally contradicts the non-reciprocity principle in Part IV of GATT (Trade and Development)[13] and Article XIX of GATS.[14]

2. *Market access for goods and government procurement*

Improving access to the markets of partner countries is the key motivation for developing-country governments to sign up to an FTA or RTA. In many cases, this motivation is likely to be reinforced by a fear of marginalization: the perceived risk of losing competitiveness vis-à-vis other developing countries, often neighbours or countries from the same geographical region that might have entered into an FTA with the same main trading partner (Shadlen, 2007). This may have played an important role in driving individual Andean and Central American countries to negotiate separate bilateral agreements with the United States: it appears to have created "an incentive for others to move ahead"[15] and to generate "a dynamic in which countries compete to become fuller members of the trading system and better partners of the United States" (USGAO, 2004).

> The elimination of tariffs and subsidies removes a powerful policy instrument for improving a developing country's supply capacities in the long run.

In the short run, several factors can circumscribe the expected outcome, even at the stage of negotiations on improved market access for sectors that are typically of interest to developing countries. Firstly, in North-South bilateral negotiations, a developing country's bargaining power is usually weaker. Secondly, even if the developed-country partner were to reduce or withdraw the export subsidies and domestic subsidies on goods produced by the developing-country partner, this may not give the latter an export advantage, because it would also benefit other exporting countries that are not partners in the FTA. Thirdly, the flexibility in what the developed-country partner can offer is often constrained by its national legislation, such as the United States Bipartisan Trade Promotion Authority Act, or very complex governance and decision-making processes, such as for EU trade and agricultural policy. Moreover, it is often difficult for developed-country negotiators to make offers of increased market opening for imports of agricultural or sensitive industrial products due to threats of a political backlash from lobby groups that are usually better organized than in developing countries. For these reasons, the major developed countries have not accepted a reduction or elimination of agricultural subsidies as a negotiable issue in bilateral agreements.[16] Consequently, developing-country partners to bilateral trade agreements are deprived of perhaps the most important potential source of increased market access in the major developed countries.

The gains for developing countries from improved market access through FTAs are not guaranteed, and may be short-lived, but the loss of policy space is certain.

Another factor limiting market access in an FTA or RTA is the restrictiveness of rules of origin for goods exported by the developing-country partner, which, in the case of NAFTA, have been found to offset the advantage of a preferential tariff (Anson et al., 2005). Moreover, owing to their limited capacity to penetrate foreign markets, developing-country partners are unable to derive the full benefits of the improved market access opportunities of an FTA, at least in the short and medium term. For instance, most of the ACP countries and the least developed countries (LDCs) have been unable to fully use their preferential access to the EU market. In addition, a number of the products in which the developing countries have a competitive advantage are "sensitive" for the developed country, and therefore likely to be excluded from the preferential treatment accorded by the FTA. Market access hopes may be additionally frustrated by developed countries' frequent use of non-tariff barriers, such as safety regulations and anti-dumping measures, that hinder imports from developing countries.

On the other hand, under an FTA, a developing country is also expected to grant improved access to its own market for suppliers of the developed-country partner through the reduction or elimination of tariffs and often also non-tariff barriers. This often results in a surge in imports, which frequently leads to a worsening of its trade balance with the developed country. The elimination of tariffs and other trade barriers in almost all categories of goods removes important and powerful instruments of industrial and agricultural policy, which, in addition to protecting its infant industries, are often indispensable for improving the developing country's supply capacities in the long run – a precondition for maximizing the potential gains from trade liberalization. Thus the gains for developing countries from improved market access are far from guaranteed; whereas they have to give up a large part of the policy space they might otherwise have used to promote the creation of new productive capacities, industrial upgrading and structural change in their economies (see *TDR 2006*, chap. II, sect. G, and chap. V, sect. D and E).

One particular aspect of market access is government procurement, an area covered by the WTO through a plurilateral agreement that is not obligatory, and indeed few developing countries have signed up to it. From 1997 to 2004 discussions were held in the WTO on a possible multilateral agreement on transparency aspects of government procurement, and the topic was included in the Doha Round agenda. Yet many FTAs already include not only transparency of government procurement, but also of market access, and the FTA partners are given national treatment rights to compete for government procurement.

The possibility of using government procurement as a policy instrument can be substantially eroded by FTAs.

This has serious developmental implications. Many developing countries apply guidelines that favour the granting of projects to local companies and people (for example by reserving some purchases or projects only for locals, or by allowing the acceptance of local bids that are higher by a certain margin than foreign ones). The scope for using government procurement as an instrument to support weaker or nascent domestic industries is considerable: public investment and other government spending on goods and services can amount to 10 per cent of GDP or more. Variations in government spending for domestically produced goods and services is also a tool of countercyclical macroeconomic policies. Moreover, government practice to source from different local suppliers can also be an actual or potential policy instrument for achieving a better balance in the economic weight of various social groups and communities within a nation.

The possibility of using government procurement as a key policy instrument in line with such domestic policy considerations is substantially eroded by an FTA that requires liberalization in this area. National treatment of foreign bidders can result in the loss of market share of local firms and of foreign exchange. It is true that a bilateral North-South FTA theoretically also gives the developing country's firms better access to the typically much larger procurement market of the developed-country partner. However, in reality, it is unlikely that a net benefit from market access for government procurement will accrue to developing countries, because generally they lack the supply capacity in the types of goods and services to be provided under an average government contract.[17]

3. *Liberalization of services*

The WTO's General Agreement on Trade in Services (GATS) allows each member to choose the extent and rate of its commitments to liberalization of trade in services to suit its conditions. It also contains some development safeguards, and clauses for special and differential treatment.[18] Thus, to some degree, a developing country retains the possibility of experimenting with liberalization of services and reversing its decision if the outcome is not beneficial.

Bilateral FTAs or RTAs also involve liberalization of services with regard to cross-border trade in services as well as the establishment of foreign service enterprises and their investments. In contrast to the more development-friendly WTO positive list approach, there is a tendency for developed countries, in particular the United States, to convince developing countries to switch to a negative list approach, which may not be to their advantage.[19] Since their service industries are typically not very advanced, trade negotiators may not be sufficiently aware of all relevant subsectors and thus not list all those they may wish to exclude from liberalization. There is also a risk that a developing country may not include in the negative list certain service sectors that it may wish to promote domestically at a later date as their strategic role becomes clear only after the negative list has been established. Or negotiators may be unaware of the risks entailed in giving up certain options for the regulation of services, but will find it difficult to backtrack when circumstances require protection of the domestic economy, as happened during various financial crises (Khor, 2007b).

> Accelerated liberalization of key service sectors can disrupt or hinder the process of establishing a national strategy for services.

Service subsectors such as banking and finance, transport and telecommunications, and medical, legal and accounting services, can play a strategic role in economic and social development. This is why many developed countries in the past and some even today as well as developing countries after the end of the colonial period, have promoted domestic and often State ownership of such activities, and restricted foreign participation in such sectors.

Strengthening domestic service sectors as a complement to industrial diversification is important for developing countries, not only because it may help to increase overall productivity through specialization at the firm level, but also because these sectors offer considerable employment opportunities due to their relatively high labour intensity, even at more advanced stages of their development. Foreign participation in service activities may be useful as a complement to the domestic provision of services, but accelerated and excessive liberalization of key sectors, or even across-the-board liberalization, under legally binding rules of an FTA has the potential to disrupt or hinder the process of establishing a national strategy for services.

4. Investment and investor protection

Liberalization of services is closely related to rules on foreign investment – another highly controversial issue at the WTO. During the Uruguay Round, developed countries sought to include investment rules in the multilateral trade negotiations, but developing countries succeeded in restricting the agreement to trade-related investment measures (TRIMs). Negotiations on investment rules were also part of the Doha agenda agreed in 2001, but following a groundswell of opposition to this at Cancun in 2003, the WTO General Council withdrew investment from the Doha negotiations agenda in July 2004. The opposition of the developing countries to the introduction of a multilateral investment agreement is based on the concern that such an agreement would significantly reduce their options to design specific investment policies geared to their development objectives, including selecting and setting conditions for foreign investment by means of entry requirements, equity structure and performance, for example with regard to technology transfer, and regulating the transfer of funds relating to foreign investment. However, in addition to international investment agreements negotiated at the bilateral, subregional or regional levels,[20] most bilateral FTAs between developing countries, on the one hand, and the EU, Japan or the United States, on the other, now include an investment chapter that reduces or prohibits the use of such instruments.

> Most bilateral North-South FTAs reduce options to design development-oriented FDI policies.

The scope and definition of investment in FTAs are usually very broad. In those involving the United States, they cover greenfield investment, portfolio investment and credit, as well as assets in the form of intellectual property rights and other tangible or intangible, movable or immovable property and related property rights. In a radical departure from past and current practice in many developing countries, foreign actors investing in any of these assets are granted pre-establishment rights, thus drastically reducing the scope for a host country to decide whether or not to approve a foreign investment or impose conditions for such an approval. Moreover, measures specifically favouring local investors through preferential treatment have to be curbed as these are seen to discriminate against foreign investors, thus violating the principle of national treatment. The investment chapter in most FTAs involving one of the major developed economies and a developing country covers all sectors and adopts a negative list approach, according to which it is assumed that every sector will be totally liberalized unless exceptions are specifically listed.

The combination of the broad definition of investment with the provisions on pre-establishment rights and free transfer of funds has the potential to increase financial instability and to prevent measures that could be taken to reduce such instability or crises. Under these conditions, several of the measures adopted successfully by Malaysia, for example, during the financial crisis of 1997–1999, such as temporary restrictions on outward capital transfers outflows by foreigners in Malaysia, would have been prohibited. Moreover, under FTAs involving the United States, investors who believe their rights have been violated and have suffered a loss can sue the host government in an international arbitration court for compensation for expropriation. The definition of the latter includes "indirect expropriation", which may include policy measures that affect the present or future revenues of a foreign enterprise.[21]

Although FTAs in general, and the inclusion of investment chapters in particular, are aimed at attracting additional FDI to developing countries, this effect is uncertain. Experience suggests that other factors, such as availability of natural resources and a well-developed infrastructure, a sizeable domestic market or strong growth in domestic industries, are as, if not more, important than fully liberalized trade and investment regimes. It is well known that a large proportion of the foreign investment in developing countries occurs as a result of private business strategies, and not because the investors *a priori* share the national development objectives of those countries. Thus, foreign investment can have positive effects for development when it happens to be in line with the national development policy agenda, but it can have negative implications when it does not. Government policy can therefore play an important role in regulating investment so as to derive positive benefits from it, while minimizing or controlling the adverse effects.[22]

5. Intellectual property rights

The inclusion of intellectual property rights (IPRs) in North-South bilateral and regional trade agreements has also been viewed critically by many observers.[23] In the context of the WTO, the Agreement on Trade-related Aspects of Intellectual Property Rights (TRIPS) sets minimum standards for compliance by WTO members, but it also contains certain flexibilities for developing countries, for example to counter anti-competitive practices of holders of IPRs, and to pursue social and development objectives. Developing countries have sought clarification on some aspects of that Agreement with the aim of reducing its potential negative effects on key areas of development. For instance the Doha Declaration on TRIPS and Public Health has clarified that, under certain conditions, developing countries can make use of flexibilities such as compulsory licences to offset the monopoly privileges of patent holders.

Similar to other controversial issues in WTO negotiations, IPRs have become an issue in bilateral and regional North-South agreements, with some major developed countries seeking to pursue objectives that go beyond the WTO TRIPS Agreement (*TDR 2006*, chap. V). Thus, many regional and bilateral trade agreements reduce the possibility for governments to set their own criteria for patentability or to use other flexibilities, such as compulsory licensing, as a policy instrument (Maskus, 1997). For example, many recent FTAs involving the United States do not allow governments to issue compulsory licences except during declared states of national emergency, or to prevent anti-competitive practices by the patent holder, or for non-commercial public use. Furthermore, some FTAs tend to extend the term of the patent beyond that contained in the WTO TRIPS Agreement, among other means, by recognizing new patents for "new uses" of an already patented product (World Bank, 2005a: 98–102; Khor, 2007b; Stiglitz, 2006). They also affect the use by developing countries of the flexibilities provided in the WTO TRIPS Agreement relating to patenting of life forms and protection of plant varieties.[24]

In addition, some FTAs oblige developing countries to introduce stricter copyright legislation, which can have adverse effects on technology transfer or access to information and information technology (IT). For example, recent FTAs involving the United States typically require countries to extend copyright protection to 70 years, compared to 50 years in the TRIPS Agreement.

> A developing country may suffer additional costs as a result of bilateral intellectual property right obligations.

Thus the developing-country partner in bilateral FTAs can be expected to incur additional costs as a result of IPR obligations that go beyond the already onerous ones of the WTO TRIPS Agreement, since most patents, copyright and other forms of intellectual property (IP) are mostly owned by foreigners. The costs entailed can take the form of increased royalty and IP licence payments (with a resulting loss of foreign exchange), or higher prices of the protected products; and there can be social costs due to reduced access to medicines and to knowledge, along with an increased threat to farmers' rights to seeds and other resources.

6. Competition policy

At first glance, competition policy is taken to mean restricting the power of large corporations, especially transnational corporations (TNCs), to prevent them from dominating the market, to facilitate market entry of newcomers and to ensure a critical number of market participants. However, in the context of negotiations over FTAs involving the United States and the EU, competition is taken as a concept closely linked to market access, giving foreign firms and their products and services the right to free competition vis-à-vis local firms in the markets of developing countries. As noted earlier, free competition in this sense implies that preferences and support given to local firms, and any advantages they enjoy compared to suppliers from the FTA partner country, are to be curtailed or eliminated. However, in many cases this attempt to create a "level playing field" is unlikely to result in greater competition in developing-country markets since, at the outset, TNCs typically enjoy the advantages of larger size, greater financial resources, more advanced technologies, better marketing networks and established brand names. From a development perspective, a genuine competition framework should incite local suppliers to become increasingly capable of competing successfully, starting with the local market, and then, if possible, internationally. Building local capacity to become and then remain competitive requires a long-term horizon, and in many cases temporary protection from the full force of the world market is needed for the time it takes to build local capacity. From this perspective, competition policy should act as a complement to other areas of policy for strategic integration. Allowing support and more favourable treatment to local firms with controlled entry to foreign competitors could enhance – rather than hamper – competition, as the smaller local firms would be given time to develop the capability to better withstand the market power of large foreign companies, which otherwise would monopolize the local market.

> A competition framework should enable local suppliers to develop the capacity to become increasingly capable of competing successfully, starting with the local market and then internationally.

FTAs that involve the United States typically require the developing country to establish competition legislation similar to that prevailing in the United States. Development economists have questioned whether the frameworks of competition policy that are in place in the developed countries are appropriate for developing countries.[25] These frameworks may hinder the growth of local firms and reduce their ability to compete or survive against large foreign firms, especially in the context of increasing globalization (Correa, 1999; Singh, 2002). By removing assistance to and protection of local companies, competition policy in the FTA would in many cases result not only in the weakening of the competitive position of local companies, but also in less competition.

7. Conclusions

In sum, bilateral North-South FTAs have the potential to provide the developing-country partner with considerable new trading opportunities. However, preferences negotiated by one developing country with a developed partner may quickly be eroded if the same developed country also concludes FTAs with other developing countries. Thus, FTAs can result in some export gains, and possibly increased FDI inflows, but the size and durability of these benefits is highly uncertain, as are the net gains for trade and output growth. This is because the FTA will most likely lead to an increase in imports, with implications for the trade balance and, in some cases, the external debt position. Moreover, if future North-South FTAs are modelled on those that have been negotiated so far, it is likely that they will considerably reduce or fully remove policy options and instruments available to a developing country to pursue its development objectives.

Another consequence of bilateral trade agreements is that they tend to weaken existing or evolving regional common markets that may offer the potential for considerable long-term gains for developing countries. If countries that are members of the same regional cooperation agreement or customs union conclude different agreements with third countries, or if some conclude such an agreement while others do not, the common external tariff and other rules governing the common market are infringed. A recent example of such an effect is the crisis that was triggered in 2006 in the Andean Community after Colombia and Peru concluded separate bilateral trade agreements with the United States. Trade agreements negotiated by the EU outside the WTO framework may carry a lower risk of such disruptions as these negotiations are not bilateral in the narrow sense, since they are undertaken with regional groups or otherwise defined groups of developing countries, such as the ACP (World Bank, 2005a: 136; Cernat, Onguglo and Ito, 2007). Nevertheless, the African Union's Conference of Trade Ministers in 2006 expressed "profound disappointment" with the EPA negotiations between the EU and African sub-groupings, which in their view did not adequately address development concerns. Specifically, they stressed that these agreements should be "consistent with the objectives and process of economic integration in Africa" and urged their development partners "to refrain from pursuing negotiating objectives that would adversely affect these existing programmes and process for economic integration in Africa" (African Union, 2006).

North-South FTAs have the potential to provide the developing-country partner with new trading opportunities ...

The proliferation of bilateral FTAs may also pose new challenges to the coherence of the multilateral system (Lamy, 2007). One of these challenges is related to the management of several PTAs with diverse countries and different terms, which may complicate the work of national customs authorities and firms. Customs administrations would have to apply different treatments and import fees to the same products, depending on their origin, and also follow different rules of origin according to the terms of each trade agreement. This may place significant pressure on the personnel and financial resources of developing countries. Furthermore, exporting firms may have to adapt their use of imported inputs to each specific market in order to comply with the rules of origin agreed in each case. More generally, this intricate network of preferential arrangements may also undermine some of the pillars of multilateralism, such as the MFN clause.

However, observers in the EU and the United States, which have been the most active in promoting bilateral North-South FTAs, believe that such agreements do not necessarily undermine the multilateral trading system; rather, that they could actually help put the multilateral negotiations back on track. From the EU perspective, bilateral agreements must "serve as a stepping stone, not a stumbling block for the widest possible openness in the global trading system" (Mandelson, 2006). And, reflecting the position of the United States, Zoellick (USGAO, 2004) stated that FTAs are part of "... a strategy of 'competitive liberalization' to advance free trade globally, regionally, and bilaterally (...) Having a strong bilateral or sub-regional option helps spur progress in larger negotiations. The recent disappointment in Cancun provides a case in point. A number of 'won't do' countries that frustrated the 'can do' spirit of Doha are now rethinking the consequences as the United States vigorously advances FTAs around the world."

... but such preferences may be eroded if the same developed country also concludes FTAs with other developing countries.

In their bid to include chapters on the "Singapore issues", such as investment, competition policy and government procurement, and other areas that have been excluded from the agenda of the multilateral trade negotiations, FTAs are thus a major vehicle for deeper integration. They lock in orthodox policy reforms that have a fairly modest record in terms of enhancing growth and structural change in developing countries and whose underlying principles have come under increasing criticism, including from within the international financial institutions (*TDR 2006*, chap. II).[26] Thus, it would be prudent for developing countries to be cautious and not to rush into North-South bilateral or regional FTAs. When assessing the potential economic and social benefits and costs of entering into such agreements, they should take into account not only the potential impact on exports and imports arising from market opening, and possible increases in FDI, but also the impact of these agreements on their ability to use alternative policy options and instruments in the pursuit of a longer term development strategy.

C. Assessing the development impact of North-South regional integration: the case of NAFTA

1. *Introduction*

When the North American Free Trade Agreement (NAFTA) between Canada, Mexico and the United States came into force in January 1994, it was the first regional agreement of this kind to involve developing and developed countries. An assessment of the effects of NAFTA from the developing-country perspective is of particular relevance, as NAFTA has often been considered a model on which to base other North-South trade agreements. In the past few years, NAFTA has been the subject of numerous studies that have produced fairly diverse and controversial results stemming from the ideological position of their authors and the methodology applied. On balance, the conclusion drawn is that the overall impact of the Agreement in terms of development gains for Mexico has been modest.

> On balance, the overall impact of NAFTA in terms of development gains for Mexico has been modest.

Estimation exercises in the run-up to NAFTA, mostly based on applied general equilibrium models, produced varied results, depending on the methodology and assumptions. A review of several of these studies by the United States Congressional Budget Office (1993) found a consensus that NAFTA would produce winners and losers, but a total net gain. The effects on Mexico were expected to be the most substantial, because of its greater trade barriers and smaller economy than those of its NAFTA partners. Most of the studies also estimated that improved resource allocation as a result of trade liberalization under NAFTA would raise Mexico's GDP, but by less than 1.1 per cent. When the effects of economies of scale were included, estimates of the increase in Mexico's GDP ranged from 1.7 per cent to around 3.4 per cent, but they were much higher if investment effects were also considered, ranging from 3.1 per cent to around 12.7 per cent. Moreover, according to this review, the most important effect would come from productivity growth. A rough comparison of these estimates with the actual real GDP growth rates in Mexico since 1994 (3.1 per cent on average per year, compared to 3.9 per cent in 1989–1993 (table 3.1)) suggests that many of these models overestimated the effects of NAFTA on Mexican economic growth. On the other hand, the models tended to underestimate the impact of NAFTA on trade expansion.[27]

Table 3.1

REAL GDP GROWTH RATES IN MEXICO AND LATIN AMERICA, 1971–2006

(Per cent)

	1971–1980	*1981–1988*	*1989–1993*	*1994–2000*	*2001–2006*
Mexico	6.4	0.6	3.9	3.6	2.3
Latin America (excl. Mexico)	5.5	2.0	1.6	2.9	3.4

Source: UNCTAD secretariat calculations, based on *UNCTAD Handbook of Statistics* database.

While the Agreement has succeeded in increasing Mexico's regional trade and inward foreign direct investment (FDI), it does not appear to have helped accelerate output growth, nor does it seem to have contributed significantly to employment growth or to much higher standards of living of the Mexican people, contrary to the expectations of many of its advocates. However, some of them suggest it was not that NAFTA failed to deliver, but that other factors, such as a credit crunch or insufficient structural reforms, prevented Mexico from deriving full benefits from the Agreement (box 3.1).

It is generally acknowledged that such an empirical assessment is rendered difficult because the effects of NAFTA cannot be disentangled from other events, such as the liberalization wave that Mexico unilaterally started in the mid-1980s, the peso devaluation and the "*tequila*" financial crisis of 1994–1995, as well as the economic cycle in the United States. However, studies on the first decade of NAFTA tend to assume that these factors were completely independent of the processes leading up to the Agreement and that, once established, NAFTA did not have any influence on them – an assumption that appears to be somewhat unrealistic.

Unilateral trade liberalization within the broader economic reform programme started in Mexico after the debt crisis of the early 1980s, and accelerated in the early 1990s in anticipation of NAFTA. Thus Mexico was already a very open economy even before the Agreement took effect. Indeed, NAFTA membership has often been regarded as a culmination of orthodox policy reforms in Mexico and as a way to lock them in (Moreno-Brid, Ruiz Nápoles and Rivas Valdivia, 2005; Lenderman, Maloney and Serven, 2003; and Kose, Meredith and Towe, 2004).

In the years preceding the creation of NAFTA, privatization of the banking sector in 1987 and the Brady Plan for debt restructuring in 1989 attracted capital inflows, which, rather than raising productive investment, were accompanied by a boom in private consumption. At the same time, the Government followed a policy of fighting inflation through an exchange-rate anchor with the dollar to reduce the inflation gap with the United States. The result of this policy, pursued in anticipation of NAFTA, was an overvalued currency in real terms and a significant current-account deficit financed by the private capital inflows, which paved the way for the "*tequila*" financial crisis. There can be little doubt that Mexico's economic performance and the evolution of the country's external economic relations have been strongly influenced by the policy decisions made in response to that crisis. Moreover, the Mexican business cycle has become more synchronized with that of the United States due to the increasing concentration of exports to this market since 1994.

This section first provides an overview of the objectives and instruments of NAFTA, and then examines how Mexico's external trade and financial relations, particularly with its NAFTA partners, have evolved since the mid-1990s. Finally, it discusses structural and macroeconomic aspects of Mexico's development in the context of the country's NAFTA membership.

2. *Objectives and instruments of NAFTA*

NAFTA treats trade liberalization, including of services, as its major objective, rather than as an instrument for enhancing growth and development or achieving income convergence.[28] In its principles, it goes far beyond market access issues involving the elimination of tariffs and the removal of non-tariff barriers in merchandise trade, to cover the liberalization of trade in serv-

Box 3.1

DIFFERING ASSESSMENTS OF NAFTA

Hornbeck (2004) provides a summary of the results of some recent analyses of the impact of NAFTA on Mexico. Among the more positive evaluations, a World Bank study by Lenderman, Maloney and Serven (2003: v) concludes that "the treaty has helped Mexico get closer to the levels of development of its NAFTA partners" but "the study argues that NAFTA is not enough. Hopes that Mexico would make bigger strides in catching up to the U.S. were diminished by under-investment in education, innovation and infrastructure, as well as low institutional quality".[a] However, Weisbrot, Rosnik and Baker (2004) challenge the conclusions of this study in terms of per capita GDP convergence, questioning the data used.

According to an IMF study by Kose, Meredith and Towe (2004: 5 and 29), "NAFTA also appears to have favourably affected Mexico's growth performance over the past decade" and "Mexico's experience under NAFTA illustrates that structural reforms are needed to sustain the benefits of comprehensive trade agreements". Tornell, Westermann and Martínez (2004) argue that the lack of spectacular growth in Mexico cannot be blamed on either NAFTA or other reforms, but on the lack of further judicial and structural reform after 1995, which aggravated the credit crunch.

However, there have also been a number of critical analyses on the effects of NAFTA. According to Moreno-Brid, Ruiz Nápoles and Rivas Valdivia (2005: 1018–1019), "The fundamental constraints on Mexico's growth have not been alleviated ... [NAFTA] has not been the success expected in terms of economic growth and job generation". Another study (Moreno-Brid, Rivas Valdivia and Santamaría, 2005) seeks to explain why the post-NAFTA economy has displayed mixed results, with low inflation, a low budget deficit and a surge in non-oil exports, on the one hand, and a slower than expected expansion of economic activity and employment on the other.

Hufbauer and Schott (2005: 2) find that during the first decade of NAFTA "Mexico's progress was insufficient to address its long-run development challenges and well below its estimated potential growth rate". According to Blecker (2003), Mexico completely failed to close the "development gap" with the United States and Canada in the first 10 years of NAFTA. Ramírez (2003) finds that the record in terms of employment growth and real wages in the manufacturing sector has been lacklustre at best and disastrous at worst, while distributional indicators performed poorly during the 1990s. Also focusing on people, Audley et al. (2003) conclude that NAFTA has not helped the Mexican economy keep pace with the growing demand for jobs, while NAFTA-led productivity growth has not translated into increased wages, and the Agreement has not stemmed the flow of Mexican emigration to the United States.

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a See the following World Bank website: http://go.worldbank.org/EJLC6GB370.

ices, including financial services, as well as other regulatory issues. Unlike some other regional agreements, NAFTA does not envisage deeper economic integration or cooperation in areas such as infrastructure, finance or social development once the members have eliminated trade and investment barriers among themselves.[29]

The institutional structure of NAFTA does not include any supranational element. The central institution is the Free Trade Commission, which consists of the three ministers responsible for international trade in the three member States. This Commission supervises the implementation of the Agreement, oversees its further elaboration, resolves disputes arising from its interpretation and supervises the work of several committees and working groups. The NAFTA Secretariat administers the mechanisms for the resolution of trade disputes between national industries and/or governments. As the three member countries have retained their own trade remedy laws, the trade dispute settlement mechanism is the main institutional instrument of NAFTA (Raynauld, 2007).[30]

In NAFTA trade liberalization is a major objective, not an instrument for enhancing growth and development or achieving income convergence.

The trade and investment aspects of the Agreement are complemented by side agreements on labour and environmental cooperation to promote better environmental performance and working conditions in North America. However, on some accounts, in order for these side agreements – and the institutions linked to them – to address the environmental and labour challenges arising from increased trade more effectively, they need to be improved.[31] Inside NAFTA, there is a predominance of bilateral cooperation between the United States and the other two partners (Pastor, 2004). An example of this kind of cooperation is the North American Development Bank, which addresses environmental issues along the United States-Mexico border region. Nevertheless, there are also examples of trilateral cooperation, such as the North American Steel Trade Committee, which brings together officials of the three governments and representatives of steel manufacturers to address critical trade issues in global steel markets.

Most tariffs were eliminated in the first 10 years of the Agreement, except for some sensitive goods, mostly agricultural, for which extended phasing out periods of up to 15 years were agreed. Given Mexico's strong dependence on the United States market, this undermines Mexico's ability to use tariffs as an instrument of strategic trade integration (*TDR 2006*: xi). The Agreement is based on full reciprocity, which means that it does not take into account the large asymmetries of the economies of the member countries, except for granting longer transition periods for sensitive Mexican products and the exclusion of some strategic sectors, such as energy. Moreover, since Mexico initially had much higher tariffs than its NAFTA partners, it had to make more substantial tariff concessions. On the other hand, the Agreement does not impose any restrictions on the use of agricultural subsidies; these are used extensively by the United States, where they account for 37 per cent of the value of total agricultural output (United States Congressional Budget Office, 2006). Restrictive rules of origin to determine which goods are entitled to preferential treatment under NAFTA are also an important part of the Agreement. Anson et al. (2005) note that the cost of complying with these rules of origin has eroded the benefits that Mexico might have gained from preferential market access. Cadot et al. (2005) arrive at a similar conclusion in their study on the textiles sector under NAFTA, suggesting there has been little improvement in market access for Mexican exporters.

NAFTA incorporates comprehensive provisions dealing with cross-border trade in services, with specific chapters for financial services and telecommunications. Liberalization of services is regulated by a negative list approach, which is more extensive than the positive list of the WTO's General Agreement on Trade in Services (GATS). As a result, many essential services, such as financial services, could be controlled by foreign interests, which entails the risk that their management may not be in line with the country's development priorities. NAFTA also facilitates the temporary cross-border movement of certain categories of persons, including business visitors, skilled labour in selected professions, intra-corporate transferees, and traders and investors (UNCTAD, 2007b); low-skilled workers who tend to migrate from Mexico to the other NAFTA members are excluded from this liberalization of cross-border movements.

NAFTA covers regulations on "deeper" integration in areas such as investment, intellectual property rights, government procurement and competition policy.

In addition, NAFTA covers "deeper" integration in areas such as investment, intellectual property rights, government procurement and competition policy, most of which are generally referred to as "WTO-plus" or "beyond-the-border" measures. Regulation in these areas may limit the flexibility available to policymakers to implement proactive policies for the creation of productive capacities and technological upgrading. Such policies played an important role in the earlier phases of development of today's most advanced countries and in the successful catching up process of some Asian economies.[32]

NAFTA includes provisions for liberalization of FDI and foreign investor protection that are more restrictive than those that have been negotiated, or are under negotiation, at the multilateral level. These provisions address all measures regulating FDI, and not only those considered "trade-related" that are regulated by the WTO Agreement on Trade-related Investment Measures (TRIMs). As in the case of services, coverage is determined by a negative list, which includes strategic sectors such as energy. Foreign investors from the United States and Canada are granted national and most-favoured-nation treatment in Mexico. The Agreement also contains "pre-establishment" rights, a ban on a wide range of performance requirements, a broad definition of expropriation, and a mechanism of dispute settlements that also deals with investor–State disputes. Thus, Mexico is prevented from using most investment measures that could support the creation of linkages between foreign investors from other NAFTA countries and local manufacturers. These measures could nurture the latter while increasing the domestic value added, thereby generating additional national income and employment, as well as encouraging the transfer of technology. In addition, the broad definition of investment in NAFTA – including portfolio investment – together with the free transfer of funds, allows virtually free capital mobility.[33]

NAFTA rules on intellectual property rights are also stricter than those of the WTO Agreement on Trade-related Aspects of Intellectual Property Rights (TRIPS), which is already quite restrictive.[34] However, as NAFTA pre-dates TRIPS and was used as a model for intellectual property regulations, the differences between NAFTA and TRIPS rules are fewer than those relating to investment.[35] The NAFTA provisions are far more constraining for Mexico than for the United States and Canada: they limit its access to technology, knowledge and medicines, and consequently reduce the possibility of learning and technological progress through imitation. In addition, the fiscal discipline imposed by the Mexican authorities has limited the resources available for public investment in research and development (R&D) and innovative activities. According to UNESCO (2005), gross expenditure on R&D as a percentage of GDP in Mexico was 0.4 per cent in 2000, below the Latin American and Caribbean average of 0.6 per cent, and much lower than the 1.8 per cent of Canada and the 2.8 per cent of the United States.

NAFTA allows Mexico little room to use industrial policy as an instrument for development.

Under the same general principles of national treatment and non-discrimination, liberalization of government procurement implies that companies from other NAFTA countries have the same access to government contracts as local companies. Thus the Mexican Government can no longer use this instrument for supporting the development of domestic firms.

Therefore NAFTA allows Mexico little room to use industrial policy as an instrument for development. Since the mid-1990s, Mexico has adopted medium- to long-term plans for the development of its industrial sector (*TDR* 2006: 182–186), but the main instrument of industrial policy has been tax exemptions for imported goods destined for re-exportation (Moreno-Brid, Rivas Valdivia and Santamaría, 2005). Other instruments, such as export subsidies, trade protection schemes or performance requirements, have been prohibited. Mexico retains the right to provide subsidies for science and technology and human capital development but, as mentioned before, fiscal discipline imposes a constraint. Regarding industrial policy, the National Plan for Development (2001–2006) had as a core objective the promotion of domestic value added and the strengthening of linkages among local production chains. It recognized a leading role for the State for promoting international competitiveness, and the need for formulating sector-specific policies. The aim was to design specific sectoral programmes in several industries, but by the end of 2006 only four had been launched: for electronics, software, leather and footwear, and textiles. In November 2006, a new programme, IMMEX, was launched to promote the manufacturing, *maquila* and service export industries. It simplified the procedures for exporting firms to apply to the PITEX programme for temporary imports of inputs for use in the production of goods for export, reduced the waiting period for value added tax (VAT) returns, and allowed firms exporting services to receive the same benefits as exporters of manufactures under PITEX. However, the change in the orientation of industrial policy, from horizontal policies to more sector-specific measures, has so far been more rhetorical than real due to insufficient budgetary funds and long delays in implementation (Moreno-Brid, 2007). Peres (2005) points out that sectoral measures have focused mainly on supporting and expanding already existing sectors, rather than promoting structural change by supporting new and innovative activities with greater potential for the generation of domestic value added.

3. *Expansion of intraregional trade and financial relations*

Since NAFTA entered into effect, intraregional trade and FDI flows have increased significantly, particularly for Mexico. The unweighted average of NAFTA intraregional exports in total exports increased from 63.5 per cent in 1990–1994 to 70.2 per cent in 2002–2006, while intraregional imports in total imports declined from 54.4 per cent to 50.3 per cent over the same period (table 3.2). Intraregional exports as a percentage of total exports increased considerably for all three member countries. The share of intraregional imports in total imports rose for the United States, but declined for Canada and Mexico. Table 3.2 also shows that intraregional trade is much more important for Canada and Mexico than it is for the United States. For Mexico, the share of exports to the United States in its total exports rose from an annual average of about 62 per cent in the 1980s to about 80 per cent in the period 1990–1995 and 86 per cent in 2001–2006 (IMF, *Direction of Trade Statistics* database), making Mexico the developing country with the highest concentration of exports to a single destination and the one with the largest increase in export opportunities from world import demand growth (*TDR 2006*: tables 3.2 and 3.5).[36] The closer integration of Mexico with the United States economy since the early 1990s has led to a convergence of the business cycles of the two countries, implying an increased dependence of Mexico's economy on the performance of the United States economy.

Table 3.2

INTRAREGIONAL TRADE OF THE NAFTA COUNTRIES, 1990–1994 AND 2002–2006

(Annual average in per cent)

	Exports		*Imports*	
	1990–1994	*2002–2006*	*1990–1994*	*2002–2006*
Canada	79.0	85.9	65.7	62.7
Mexico	81.9	88.2	72.5	60.6
United States	29.6	36.5	25.1	27.6
NAFTA[a]	63.5	70.2	54.4	50.3

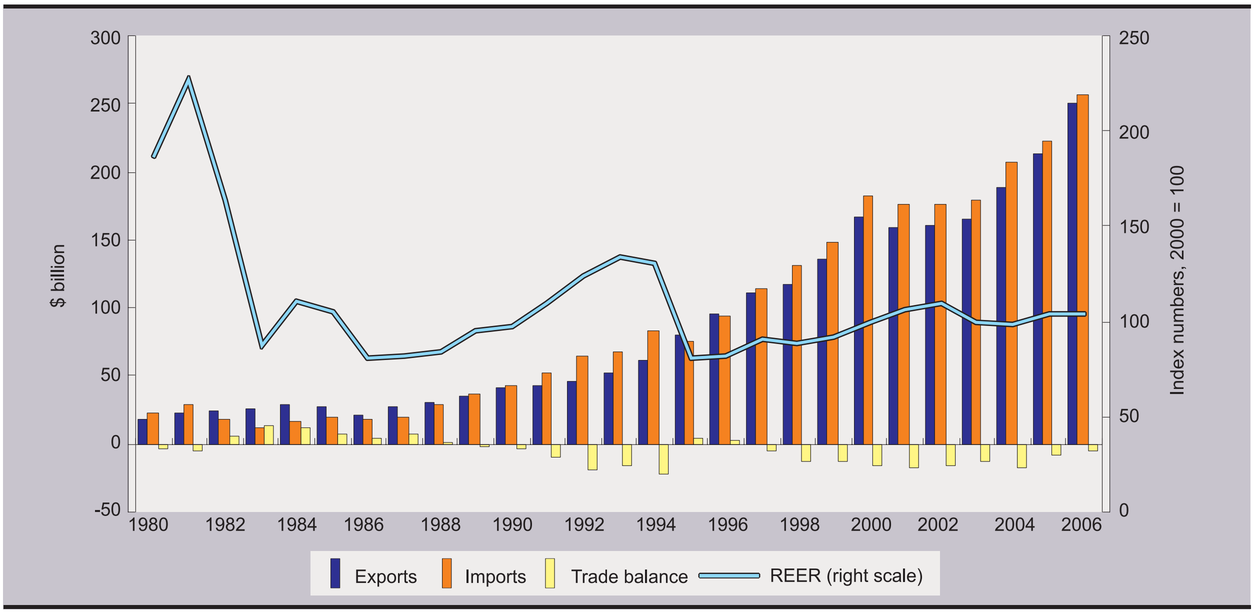
Source: UNCTAD secretariat calculations, based on IMF, *Direction of Trade Statistics* database.
a Unweighted average.

Mexico's total exports surged, growing at an average rate of 11.3 per cent during the period 1994–2006, compared to 7.1 per cent between 1981 and 1993. The share of Mexico in total world trade increased from 1.4 per cent in 1994 to 2.6 per cent in 2000, but then declined to 2.1 per cent in 2006 (*UNCTAD Handbook of Statistics* database). Imports grew at similar rates, and by 2006 they were over three times their value of 1994. This is primarily the result of the increasing structural dependence of the Mexican economy on imports (Moreno-Brid, Rivas Valdivia and Santamaría, 2005), partly due to the high import content of Mexican exports, particularly in the *maquiladora* sector.[37]

Figure 3.2

MEXICO: EXPORTS, IMPORTS, TRADE BALANCE AND REER, 1980–2006

(Billions of dollars and index numbers)



Source: UNCTAD secretariat calculations, based on *UNCTAD Handbook of Statistics* database; and OECD, *Factbook 2007* online.

As a result, overall, Mexico's trade balance has been in deficit since 1994, except during the period 1995–1997 (i.e. in the aftermath of the *tequila* financial crisis and under the influence of a sharp currency devaluation) (fig. 3.2). By contrast, Mexico has registered an increasing trade surplus with the United States, which is mainly a reflection of that country's large trade deficit. But this surplus is not sufficient to compensate for Mexico's overall trade deficit with the rest of the world. It has also recorded a current-account deficit in all the years that NAFTA has been in force. Indeed, in the early 2000s the current-account deficit approached the levels of the period prior to the peso devaluation of 1994, but thereafter these levels fell.

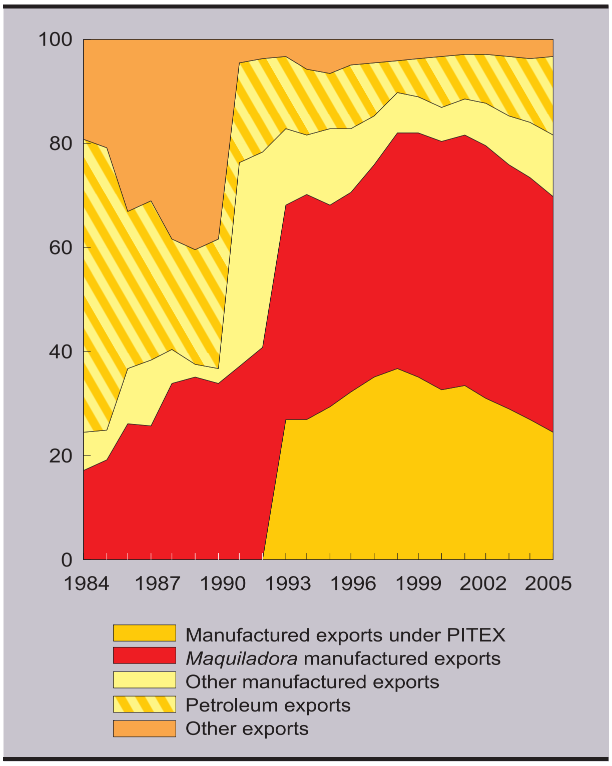
The composition of Mexican exports has changed dramatically since the 1980s. At the beginning of that decade, in a period of relatively high oil prices, this commodity accounted for around 60 per cent of its total exports. Towards the end of the 1990s, the share of oil fell to 10 per cent, and since then it has risen slightly as a result of the new oil price hike. There has also been a significant decline in the share of agricultural products in total exports. On the other hand, the share of manufactures in total exports increased from around 30 per cent in the early 1980s to close to 90 per cent by the late 1990s, although it subsequently fell to around 80 per cent in 2005 and 2006 (fig. 3.3). However, this is not just a feature of the NAFTA period, since even before NAFTA, between 1981 and 1993, there was already rapid export growth of manufactures. Moreover, Mexico's manufactured imports have consistently been growing as fast as its exports (fig. 3.4).

Mexico is a major exporter among developing countries of manufactured goods, such as textiles and clothing, automobiles and automotive parts, and electrical and electronic goods,[38] which have been very important in international production networks. In the labour-intensive textiles and clothing sector, increasing bilateral trade between Mexico and the United States following the creation of NAFTA was a sign of the regionalization of trade; regulations under NAFTA have favoured

Figure 3.3

STRUCTURE OF MEXICO'S EXPORTS, BY TYPE, 1984–2005

(Per cent)



Source: UNCTAD secretariat calculations, based on *Secretaría de Economía, Estadísticas de Comercio Exterior del Sector Manufacturero* and *Information on PITEX*, at: www.economia.gob.mx; *Banco de Mexico* database, at: www.banxico.org.mx/; and Capdevielle, 2005.
Note: Other exports comprise agricultural commodities and extractive industries.

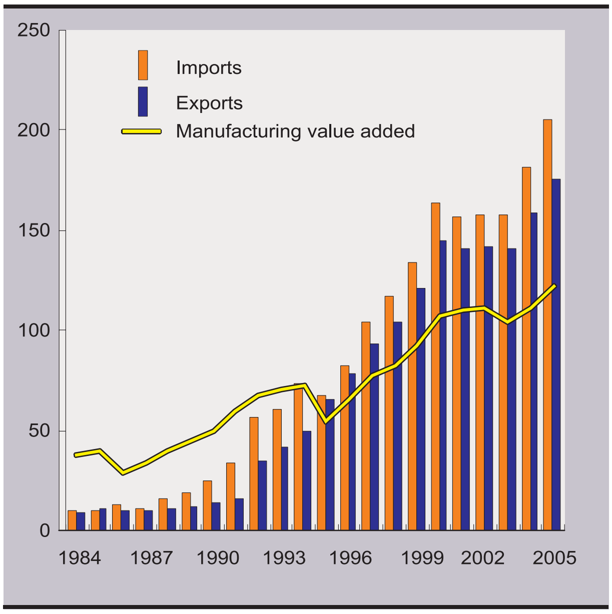
an ongoing transition from assembly to a more full-package type of production in Mexico. Moreover, NAFTA rules of origin provided an advantage, as Mexican inputs into goods for export count as North American inputs and are not taxed at the United States border. A similar pattern of bilateral trade in electronic goods between the United States and Mexico has evolved since the mid-1990s. NAFTA also gave new momentum to the Mexican automotive industry, which had originally been established in the 1960s in the context of import-substituting industrialization. It further deepened a restructuring process in terms of productivity levels and export orientation, as it provided preferences that benefited United States transnational corporations (TNCs) and extended regional rules of origin to producers of non-American origin, including component producers. Thus the surge in bilateral trade after NAFTA appears to have consolidated the position of Mexican producers as part of the regional industrial bloc. It also consolidated a process of regional restructuring as a result of leading United States producers intensifying production sharing through offshore assembly sites (*TDR 2002*: annex 3 to chap. III).

Exports of the *maquiladora* sector, which grew at an average rate of 12.6 per cent between 1994 and 2006 made an important contribution to the country's average growth in manufactured exports of 11.5 per cent. However, *maquiladora* industries are confined to labour-intensive, assembly-

Figure 3.4

MEXICO: TRADE AND VALUE ADDED IN MANUFACTURES, 1984–2005

(Billions of dollars)

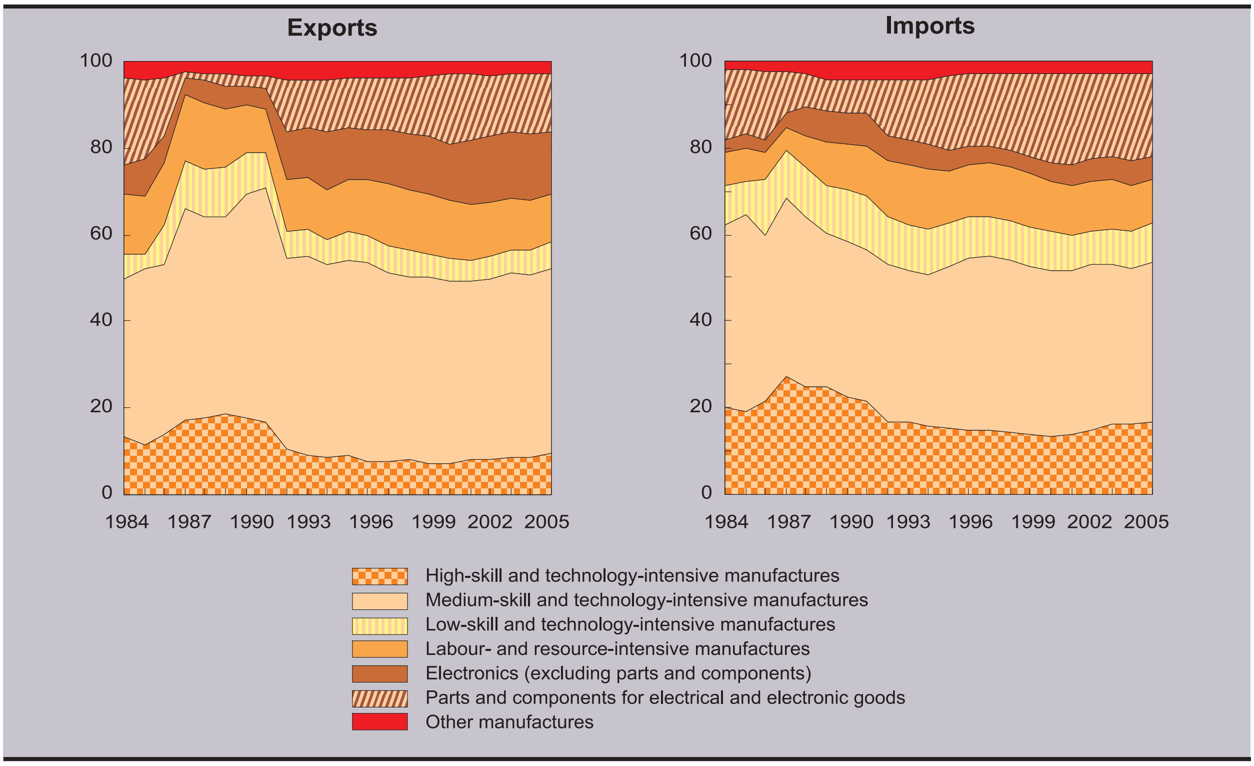


Source: UNCTAD secretariat calculations, based on *UNCTAD Handbook of Statistics* database; and UN COMTRADE.
Note: To ensure data comparability, the definition of manufactures in trade data follows the ISIC classification of industrial statistics. It therefore includes processed primary products in addition to manufactures as defined in trade statistics.

Figure 3.5

COMPOSITION OF MEXICAN MANUFACTURED EXPORTS AND IMPORTS BY BROAD PRODUCT CATEGORY, 1984–2005

(Per cent)



Source: UNCTAD secretariat calculations, based on UN COMTRADE.
Note: For the composition of product categories, see the notes to chapter IV.

type activities, with little domestic value added. *Maquiladora* exports represented on average 27 per cent of total Mexican exports and about 48 per cent of manufactured exports during the period 1981–1993. These shares increased to 45 per cent and 52 per cent, respectively, in the subsequent period, 1994–2006.

In the context of Mexico's surging trade since the early 1990s, it is interesting to look at the composition of trade in manufactures by skill and technology intensity. It is also important to consider not only the types of products exported but also the processes involved in exports: a high-technology content in export products may result from low-technology processes. All product categories of manufactured exports experienced rapid growth between 1994 and 2005. However, their composition by skill and technology intensity remained relatively unchanged over this period. Medium- and high-skill and technology-intensive manufactures represented over half of total manufactured exports, while low-skill and technology-intensive and labour- and resource-intensive manufactures accounted for only about 17 per cent of total manufactured exports (fig. 3.5). But, despite the fact that a significant proportion of Mexican exports are classified as skill- and technology-intensive products, Mexican firms have been involved mainly in the low-skill, assembly stages of the production of such goods (*TDR 2002*: v, 53). The technology content of Mexico's exports may be high, but this does not necessarily imply domestically generated high-technology inputs.

Compared to exports, manufactured imports, which also grew rapidly, consisted of a larger proportion of high-skill and technology-intensive products and electronic parts and components in total manufactured imports. The data also point to the growing importance of intermediate goods in imports. Much of this is related to the increasing weight of the *maquiladora* industry in manufactures, which uses only about 2 per cent of inputs of local origin (Pacheco-López, 2005) and has low linkages with the rest of the economy. Exports of the *maquiladora* industry, together with those of the PITEX programme – an assembly programme which displays similar characteristics to the *maquiladoras* in terms of its high import content – reached about 90 per cent of total manufactured exports, on average, between 2000 and 2005 (fig. 3.3). Thus, even though there has been diversification in Mexican exports since the 1980s, with a reduction in the share of commodities in total exports, trade specialization in manufacturing is focused mainly on labour-intensive processes. Trade liberalization and NAFTA have maintained the static comparative advantage of Mexico in low-cost labour. Nonetheless, Palma (2005) highlights the potential of non-*maquila* manufactured exports to contribute to catch-up growth through acquired comparative advantages and technological upgrading.

Mexican trade specialization in manufacturing remains focused on labour-intensive processes.

The sustainability of Mexico's export growth, which relies heavily on the supply of cheap, low-skilled labour, is challenged by increasing competition from lower cost exporters in Asia, especially China since its accession to the WTO in 2001. In addition, the extension of trade preferences by the United States to other developing countries through bilateral and regional agreements may considerably reduce any "first-mover" advantages Mexico may have had from its membership of NAFTA. Increased global competition is already reflected in the reduced dynamism of some important export products in Mexico in the 2000s. Indeed, while the share of Mexico's manufactured exports in world exports increased from 1.4 per cent in 1994 to 2.7 per cent in 2000 and 2001, it declined subsequently to 2.1 per cent in 2005 (table 3.3). *TDR 2005* (table 2.10) showed, for example, how the market share of Mexico in United States apparel imports grew considerably up to 1999 but declined thereafter.

Mexico has also benefited from a sharp increase in FDI inflows since 1994, in a context of an overall expansion of FDI flows to developing countries. Although FDI flows to Mexico have shown considerable volatility related to various developments in the global economy, such as the Asian financial crisis or the slowdown of the United States economy in the early 2000s, the overall trend has been positive. On average, between 1990 and 1994 FDI inflows into Mexico were in the order of $5 billion, rising to about $19 billion in 2000–2004.[39] FDI stocks as a percentage of GDP increased from 8.5 per cent in 1990 to 27.3 per cent in 2005, when Mexico ranked fourth among developing countries as a recipient of FDI flows and third in terms of FDI stock (UNCTAD *WIR* database). The United States has been the main source of FDI to Mexico, its share in Mexico's total inward FDI increasing from 47 per cent in 1994 to 64 per cent in 2006. During this period, on average, 54 per cent of foreign investment went to the manufacturing sector. However, since the late 1990s, FDI in services has become more important, particularly in financial services (Secretaría de Economía, *FDI Statistics*).

FDI flows to Mexico have been motivated mainly by low labour costs and its geographical position as an export platform to the United States. Mexico has become a major player in the context of international production networks to serve global and regional markets, primarily the United States market. The global fragmentation of production has resulted in Mexico increasingly importing parts and components for assembly and re-export to the United States. Thus an important part of the value added contained in these products accrues to foreign owners of capital, know-how and management. NAFTA has encouraged this process through the preferential market access granted to goods produced by the Mexican assembly operations of Canadian and United States TNCs, as well as to goods that contain inputs originating in these countries. The process has also been helped by fiscal and other incentives to attract FDI, offered in the hope that TNCs would provide technological and knowledge spillovers to domestic producers. However, the

Table 3.3

MEXICO: NAFTA-RELATED PERFORMANCE INDICATORS

(Per cent)

	1990	*1994*	*2001*	*2005/06*
Manufactured exports as a share of world manufactured exports	0.5	1.4	2.7	2.1
Manufacturing value added as a share of world manufacturing value added	1.1	1.4	2.0	1.7
Total manufactured exports as a share of GDP	5.2	11.8	22.6	22.9
Manufactured exports to NAFTA as a share of GDP	4.0	10.6	20.8	20.5
Manufacturing value added as a share of GDP	20.6	18.2	19.2	17.5
Inward FDI stock as a percentage of GDP	8.5	7.9	22.6	27.3
GDP per capita as a percentage of United States GDP per capita (PPP)	26.9	27.1	26.1	24.4
Ratio of gross fixed capital formation to GDP	17.9	19.4	20.0	19.3
Inflation	29.9	7.1	4.4	4.1
Mexican nominal wage as a percentage of United States nominal wage (in manufactures)	..	17.5	16.9	17.3

Source: UNCTAD secretariat calculations, based on *UNCTAD Handbook of Statistics* database; UN COMTRADE; World Bank, *World Development Indicators* database; UNCTAD, *WIR* database; and Instituto Nacional de Estadística, Geografía e Informática (INEGI) database.

Note: To ensure data comparability, the definition of manufactures in trade data follows the ISIC classification of industrial statistics. It therefore includes processed primary products in addition to manufactures as defined in trade statistics.

problem with this efficiency-seeking kind of FDI is that it has failed to establish strong linkages with Mexico's domestic economy because it has rarely gone beyond assembly activities.[40] According to some observers, this has led to a dual economy, with a relatively small number of firms in the export-oriented sector benefiting from this investment, particularly in the northern part of the country, while the rest of the economy has been lagging behind (Moreno-Brid, Rivas Valdivia and Santamaría, 2005; Pacheco-López, 2005).[41]

4. *Mexico's economic and social performance after NAFTA*

Mexico's strong export growth and FDI inflows under NAFTA have not translated into similarly strong economic and social progress. Indeed, the outcome of NAFTA has been disappointing with regard to key macroeconomic variables and social indicators.

Mexico's share in world manufactured exports almost doubled between 1994 and 2001 – declining subsequently – while its share in world manufacturing value added rose much less (table 3.3). Moreover, the share of manufactured exports in Mexican GDP rose significantly during the 1990s as a result of increased participation in international production networks, but the share of manufacturing value added in GDP fell. Both these shares have been exhibiting a declining trend since the beginning of the new millennium. Figure 3.4 shows how Mexico's imports and exports of manufactures have been significantly exceeding manufacturing value added since 1994, although previously it was the reverse. Moreover, growth in value added has been low in comparison with the surge in manufactured imports and exports, leading to a declining share of value added in exports.[42]

Since NAFTA came into effect, Mexican GDP growth has been unstable, following closely the business cycle of the United States. However, from a medium-term perspective, the launching of NAFTA did not improve the Mexican growth trend, nor did it help to narrow the gap between Mexican per capita GDP and that of the other member countries. Regarding growth, Mexico's average post-NAFTA GDP growth rate of 3.6 per cent in 1994–2000 was slightly below that of 1989–1993, though higher than that of the rest of Latin America and the Caribbean. It then fell in 2001–2006 to an average of 2.3 per cent per annum, almost 1 percentage point lower than for the rest of the region (table 3.1). The income gap with the United States, which had widened dramatically during the "lost decade" of the 1980s, widened further after 1994: in 1982, the Mexican per capita GDP in PPP terms was 38.4 per cent that of the United States; that ratio declined to 27.1 per cent in 1994, and to 24.4 per cent in 2005 (table 3.3).

Mexico's strong export growth and FDI inflows under NAFTA have not translated into similarly strong economic and social progress.

The share of exports in Mexico's GDP, in current dollars, jumped from 17 per cent in 1994 to 30 per cent in 1995, largely due to the devaluation of the peso, and it has remained at around that level ever since. However, the share of imports in GDP expanded at a similar pace, from 21.7 in 1994 to 31.6 in 2005. As a result, the contribution of net exports to real GDP growth has been very low (1 per cent between 1994 and 2005). Rather, it was private consumption that contributed to about three quarters of real GDP growth between 1994 and 2005. Similarly, the contribution of investment (about 18 per cent) to real GDP growth has been higher than that of net exports, albeit still low (ECLAC, 2006a). Thus, despite its spectacular export growth, it cannot be concluded that Mexico has witnessed export-led growth.

As already mentioned, FDI inflows as a percentage of GDP are on average higher than before NAFTA. However, this has not translated into an increased share of gross fixed capital formation (GFCF) in GDP, which has remained at around 20 per cent (table 3.3). This level is well below the 25 per cent that is generally understood to be required for a sustained process of catch-up growth in a middle-income developing country such as Mexico (*TDR 2003*: 61). A dynamic nexus between exports, domestic investment and income growth that would allow Mexico to rapidly narrow the income gap with its developed NAFTA partners thus remains to be established.

There is no evidence of accelerated change in the structure of production of the Mexican economy since the early 1990s.[43] The relative share of industrial value added in GDP remained almost the same between 1994 and 2005, while that of services increased slightly at the expense of agriculture (UNCTAD *Handbook of Statistics* database). In its industrial activities, there was some increase in the share of technology-intensive production, from 32.5 per cent in 1994 to 37.3 per cent in 2003. This was probably associated with the growing activities in the automotive industry after the creation of NAFTA. However, resource-intensive manufactures have maintained the largest share in the country's industrial activity, even though it declined from 47.2 per cent in 1994 to 45.4 in 2003. The share of labour-intensive manufactures also declined from 20.2 to 17.4 per cent over the same period (*TDR 2006*, fig. 5.2).

In certain other sectors, liberalization of trade and services under NAFTA has had serious negative consequences. In agriculture, producers of maize, which is a major staple food crop for Mexico, have been adversely affected by an increase in imports from the United States. Corn prices fell due to the Mexican market being flooded with cheaper imported corn produced more efficiently and heavily subsidized. The smallest and poorest farmers, unable to compete, have suffered the most. The increase in exports of some agricultural products, mainly fruit and vegetables, has not been strong enough to compensate for the substitution of domestic agricultural products through imports of others (Khor, 2007b). According to Zahniser (2007), United States exports of grains and feeds and oilseeds products to Mexico increased almost threefold between 1991–1993 and 2003–2005, while its exports of animals and animal products to Mexico doubled, and exports of corn increased sixfold over the same period. As a result of Mexico's liberalization of its financial services, foreign ownership of the banking system rose to about 80 per cent by the end of 2005 (IMF, 2006). So far, restructuring of the banking system has not improved access to credit: indeed, bank credit to the private sector as a proportion of GDP declined from 32.2 per cent in 1994 to 16.7 per cent in 2006 (IMF, *International Financial Statistics* database).[44]

Increasing trade and FDI flows should not be considered an end in itself ...

The banking and balance-of-payments crisis that struck shortly after NAFTA was launched had a strong influence on much of the subsequent macroeconomic situation. Inflation rose to more than 50 per cent in 1995 and the real effective exchange rate (REER) depreciated markedly. Macroeconomic policy was successful in cutting inflation without new shock therapies. Since 2001, the inflation rate has remained below the pre-crisis level, and has continued to fall to reach 4.1 per cent in 2006 (INEGI database), as the Bank of Mexico has been strongly committed to its inflation target through tight monetary policies. Meanwhile, the REER has tended to appreciate, especially between 1995 and 2002, although it still remains below the pre-crisis level (fig.3.2). The relatively strong peso has contributed to the erosion of the advantages that NAFTA offers to export industries and has reduced Mexico's export competitiveness vis-à-vis other developing countries. Mexican exporters who are not integrated into international production networks are affected the most, because given the high import content of TNCs' exports the latter benefit from access to cheaper inputs as a result of the REER appreciation.

... it can lead to faster development when combined with policies, at the national and regional levels, that encourage fixed capital formation and technological upgrading.

Employment creation is a huge challenge for Mexico, with about one million people joining the labour force every year. Partial evidence shows that total employment has increased at a rapid rate,[45] while the open unemployment rate has been maintained at a fairly low level: at 3.5 per cent in 1994 and 4.0 per cent in the first quarter of 2007. If underemployment (i.e. those working less than 15 hours a week) is also taken into account, the unemployment rate rises to 10 per cent in the first quarter of 2007 (INEGI database and OECD, 2007). However, the majority of new jobs created were in the non-tradables sector (3.9 per cent), whereas employment growth was relatively modest in the tradables sector (1.7 per cent). Moreover, a considerable proportion of the employment was created in low-productivity or informal activities, according to the ECLAC classification (ECLAC, 2006b). According to Polaski (2006), since NAFTA took effect, the most dramatic impact on employment has been in agriculture, where about 2 million jobs have been lost, partly due to increased imports. The share of the agricultural sector in total employment fell from 25.7 per cent in 1993 to 14.3 per cent in 2006. This seems to have been absorbed mainly by the services sector, which increased its share in total employment from 51 per cent to 60 per cent over that period. In manufactures, about 700,000 jobs were created over the same period, mainly in export-oriented manufactures, against 130,000 jobs lost in domestic manufacturing due mainly to the substitution of formerly domestically produced inputs by imports. The rising trend of employment in manufacturing has been reversed since the early 2000s.

Although NAFTA may have led to a growth in labour productivity, the productivity gap with the United States has widened, and real wages, which had declined sharply during the 1994 crisis, have not grown in parallel.[46] Indeed, the real wage index remains lower than in 1994. Since the creation of NAFTA, Mexico has made progress in reducing poverty, but income inequality remains high. The percentage of people living below the poverty line fell from 45.1 in 1994 to 35.5 in 2005,[47] and the ratio between the average income of the richest 10 per cent of the population and the poorest 40 per cent declined slightly, from 17.3 to 16.7 (ECLAC, 2006b). On the other hand, as NAFTA has contributed to better growth performance primarily in the northern parts of Mexico, through an expansion of exports and an increase in FDI, regional disparities have been growing. For instance, in 1993 the GDP per capita of the poorest state, Oaxaca, was 18.4 per cent of that of the richest state, the Federal District, compared to only 16.2 per cent in 2002 (Escobar-Gamboa, 2006).[48]

Perhaps the greatest disappointment with NAFTA has been that it has failed to stem migration from Mexico to the United States, particularly illegal migration, which carries high social costs. Since the standard of living and employment opportunities of the Mexican people have not significantly improved and the wage gaps with the United States have not narrowed, incentives for migration remain strong. Indeed, Mexican migration to the United States accelerated in the 1990s. The number of Mexicans obtaining legal permanent resident status in the United States almost tripled compared to the 1980s, and the share of Mexicans in the employed population in the United States rose from 3.1 per cent in 1995 to 4.8 per cent in 2005. In addition, unauthorized immigration has remained high, the number of Mexicans living without legal resident permits in the United States being close to 6 million in 2005. The boom in workers' remittances from the United States to Mexico has mirrored these trends in migration. Between 1994 and 2006, remittances to Mexico increased sixfold.[49] Remittances can be considered the positive side of migration for Mexico, as they can contribute to poverty alleviation and the financing of small-scale ventures, but their growing size also indicates that NAFTA has not significantly contributed to solving the structural problems of the Mexican economy that lead to migration in the first place.

To sum up, while it is difficult to identify precise causalities between NAFTA and the structural and macroeconomic trends in Mexico over the past 15 years, it can nevertheless be concluded that, since the creation of NAFTA, Mexico has witnessed spectacular expansion in trade and FDI flows and relative macroeconomic stabilization. However, NAFTA has produced disappointing results in terms of growth and development. In spite of its privileged access to the largest and most dynamic market in the industrial world and the large FDI inflows, the Mexican economy has so far not been able to establish a dynamic process of industrialization and structural change. The Mexican experience in NAFTA confirms that, in order to strengthen capital accumulation to expand productive capacities, technological upgrading and growth of domestic value added in manufacturing, regional cooperation should not be limited to the dismantling of barriers to trade and investment flows. And the rules associated with regional cooperation agreements should not prevent the poorer countries from pursuing a proactive industrial policy. Increasing trade and FDI flows should not be considered an end in themselves; rather, they should be a means to faster growth and development when combined with appropriate policies that favour fixed capital formation and technological upgrading, including at the regional level. Given the large asymmetries between the NAFTA member countries, the Agreement should have included some kind of compensatory funding mechanism to assist with the adjustment costs of the integration process and for developing infrastructure in the poorest areas. Compensation funds would be of particular importance for Mexico, the poorest member of NAFTA. ■

Notes

1 RTAs, in the WTO terminology, reflect provisions in Article XXIV of GATT 1994 (and the Uruguay Round Understanding on that Article), as well as Article V of GATS on Economic Integration. The WTO has the Committee on RTAs under its organizational structure. However, most of the South-South RTAs are functioning under the GATT Enabling Clause (1979) and are reported to the WTO Committee on Trade and Development.

2 See for example, Breslin et al., 2002; and Burfisher, Robinson and Thierfelder, 2003.

3 These figures do not include agreements that may already have been in force but were not yet notified to WTO. The World Bank estimated that there were a total of 230 trade agreements by 2005 (World Bank, 2005a: 28).

4 COMECON, founded in 1949, comprised Bulgaria, the former Czechoslovakia, Cuba, the former German Democratic Republic, Hungary, Mongolia, Poland, Romania, the former Soviet Union and Viet Nam. The organization was dissolved in 1991.

5 United States FTAs exist with Bahrain, Chile, Costa Rica, the Dominican Republic, El Salvador, Guatemala, Honduras, Jordan, Morocco, Nicaragua, Oman and Singapore. As of June 2007 agreements with Colombia, Panama, Peru and the Republic of Korea were awaiting approval by the United States Congress, and ratification by Costa Rica's Parliament is also pending (see also McMahon, 2007).

6 For a survey of United Sates RTAs and FTAs with developing countries at different stages of completion, see USTR, 2007.

7 The EU is in the process of negotiating separate EPAs with six regional groupings (four in Africa, and one each in the Caribbean and the Pacific regions), with a view to replacing the Cotonou agreement that is scheduled to expire at the end of 2007.

8 Algeria, Chile, Egypt, Morocco, the Palestinian Authority, South Africa and Tunisia. In late 2006, the European Commission announced its intention to pursue additional FTAs with several Asian countries, including members of the Gulf Cooperation Council and the Association of Southeast Asian Nations (ASEAN), as well as India and the Republic of Korea.

9 These agreements are being negotiated between the EU and six regional bodies of 75 ACP countries: the Common Market for Eastern and Southern Africa (COMESA), the Economic and Monetary Community of Central Africa (CEMAC), the Economic Community of West African States (ECOWAS), the Southern African Development Community (SADC), the Caribbean Forum, and the Pacific countries of the ACP.

10 "... the Parties agree to conclude new WTO-compatible trading arrangements, removing progressively barriers to trade between them and enhancing cooperation in all areas relevant to trade" (Cotonou Agreement, Chapter 2, Art. 36.1) The GATT/WTO article related to FTAs (Art. XXIV, 8.b) does not permit non-reciprocal trade conditions within such agreements: "A free-trade area shall be understood to mean a group of two or more customs territories in which the duties and other restrictive regulations of commerce (except, where necessary, those permitted under Articles XI, XII, XIII, XIV, XV and XX) are eliminated on substantially all the trade between the constituent territories in products originating in such territories."

11 As a United States official report put it: "Under the Caribbean Basin Initiative, U.S. tariffs on Central American goods are already low, with 74 percent of CAFTA country imports entering the United States duty-free in 2002. An FTA would enable the United States and the CAFTA countries to have reciprocal tariff levels and would remove the requirement that Caribbean Basin Initiative preferences be reviewed every year" (USGAO, 2004).

12 For a discussion of the practical aspects of this issue, see Scollay (2005); Cernat, Onguglo and Ito

(2007) offer an analysis of the implications of some recent reform proposals.

13 GATT Article XXXVI, paragraph 8: "The developed contracting parties do not expect reciprocity for commitments made by them in trade negotiations to reduce or remove tariffs and other barriers to the trade of less-developed contracting parties".

14 GATS Article XIX, paragraph 2: "The process of liberalization shall take place with due respect for national policy objectives and the level of development of individual Members, both overall and in individual sectors. There shall be appropriate flexibility for individual developing country Members for opening fewer sectors, liberalizing fewer types of transactions, progressively extending market access in line with their development situation ..."

15 Comment by the Deputy United States Trade Representative, quoted in *Business Week*, 16 June 2003 (cited by Shadlen, 2007).

16 The United States argues that the subsidy issue can be dealt with only at the WTO.

17 Data from the United States Federal Procurement Data System (USFPDS, 2007) suggests that in 2005, 94 per cent of the payments made by the Federal Government went to companies located in the United States, leaving only 6 per cent to all suppliers from the rest of the world, which represented around 0.8 per cent of GDP. After the FTA between the United States and Chile came into force in January 2004, Chilean suppliers obtained government procurement orders from the United States worth $635,516 in 2004 and $233,570 in 2005, compared to $32,090 in 2003 (TWN, 2007). This is, no doubt, a huge increase, but from an almost negligible level.

18 These development provisions are contained notably in Articles IV and XIX (2) of the GATS, and in the Guidelines and the Procedures for the Negotiations on Trade in Services of March 2001.

19 In the positive list approach, countries commit to liberalize only in those areas and to the extent specified in the list, while in the negative list approach it is assumed that there is full liberalization in all sectors except those listed.

20 For an assessment of the development dimension of international investment agreements, see UNCTAD, 2003, Part Two).

21 In view of the claims under NAFTA, some FTAs and RTAs have clauses to limit investor protection from government (see UNCTAD, 2006a). The FTA between the United States and the Republic of Korea, for example, has a special annex (Annex 11-B) that aims at clarifying the criteria for indirect expropriation and excludes "appropriate" policy in certain important economic sectors from indirect appropriation.

22 For a discussion of the impact of international investment rules on options for national development policy, even under the softer conditions of multilateral agreements, see Cho and Dubash (2005).

23 See, for example, Chang, 2005; Correa, 2005 and 2006; Maskus, 1997; and Shadlen, 2005b.

24 The WTO TRIPS Agreement allows countries to exclude the patenting of plants and animals. However, FTAs involving the United States, such as the one signed by Chile, require the patenting of plants that are "new, involve an inventive step and [are] capable of industrial application". TRIPS also allows countries to have a *sui generis* system of protection of plant varieties, while FTAs involving the United States require the partner countries to subscribe to the Convention for the Protection of New Varieties of Plants (revised in 1991), which provides strong intellectual property protection for plant varieties that may adversely affect the rights of small farmers in saving and exchanging seeds (Khor, 2007b). For more details on TRIPS and bilateral agreements, particularly with LDCs, see UNCTAD, 2007a.

25 Comparing United States, EU and Japanese competition legislation from a development perspective, Singh (2002) concludes that the kind of competition policy adopted by Japan in the 1950s and 1960s, when that country was at a similar level of development as many emerging market economies today, may be more suitable for most developing countries. At the time, Japanese competition legislation served as a tool to restrict the intrusion of large foreign firms and their products, on the one hand, and to nurture and strengthen Japanese firms so that they could develop and eventually successfully compete with those large foreign companies, on the other. The kind of model represented by the Japanese example, in which competition policy is complemented, if not subsumed, under industrial policy, would not be permitted in the kind of competition agreement propounded in today's FTAs. Indeed, they would seek to outlaw the Japanese-style model that developing countries may find consistent with their development needs.

26 See also Ocampo and Taylor, 1998; Stiglitz, 1998, 2002; Rodrik, 2004, 2006; IMF/IEO, 2005; and World Bank, 2005b.

27 See, for instance, Kehoe, 2003.

28 See Preamble to NAFTA Agreement. The specific objectives of the Agreement are stated in its Article 102: "The objectives of this Agreement, as elaborated more specifically through its principles and rules, including national treatment, most-favoured-nation treatment and transparency, are to: (a) eliminate barriers to trade in, and facilitate the cross-border movement of, goods and services between the territories of the Parties; (b) promote conditions of fair competition in the free trade area; (c) increase substantially investment opportunities in the territories of the Parties; (d) provide adequate and ef-

fective protection and enforcement of intellectual property rights in each Party's territory; (e) create effective procedures for the implementation and application of this Agreement, for its joint administration and for the resolution of disputes; and (f) establish a framework for further trilateral, regional and multilateral cooperation to expand and enhance the benefits of this Agreement."

29 Additional steps towards regional economic cooperation or integration inside NAFTA require the signature of new agreements. One such agreement is the Security and Prosperity Partnership of North America, which was launched in March 2005 as a trilateral effort to increase security and enhance prosperity. Its priorities are emergency management, addressing influenza pandemics, energy security, and safe and secure gateways (see Security and Prosperity Partnership of North America, at: www.spp.gov/). In 2001, the President of Mexico proposed a deepening of integration and the creation of a North American Community. This would include integration of infrastructure and transportation networks, the creation of a development fund to reduce income disparities among the member countries, the establishment of a North American Commission, a move towards a customs union and eventually a common currency, and forging a more humane immigration policy (Pastor, 2001). However, the other members did not follow-up on this proposal.

30 The NAFTA Secretariat comprises the Canadian, Mexican and United States sections, each a "mirror image" of the other. They are headed by secretaries, who, while appointed by their respective governments, function independently of them. The three secretaries work on a consensus basis, and report to the Free Trade Commission.

31 See, for instance, Hufbauer and Schott, 2005.

32 Recent discussions on the policy space limitations that developing countries face when entering into FTAs with developed countries can be found in Shadlen, 2005a; Khor, 2007a; and Oxfam, 2007. For a discussion on policy autonomy in the multilateral framework, see *TDR 2006*, chap. V.

33 For a case study on the investment provisions under NAFTA, see Lesher and Miroudot, 2006. UNCTAD (2006b) discusses how the NAFTA model on investment-related measures has been followed in many other bilateral and regional agreements.

34 According to Vivas-Eugui (2003: 7), "In NAFTA, TRIPS-plus standards include the extension of coverage (i.e. protection of plant varieties based on UPOV's [International Union for the Protection of New Varieties of Plants] models or protection of program-carrying satellite signals) or limitations in flexibilities that were later agreed to at the international level in the TRIPS Agreement (i.e. causes for the revocation of patents are limited to cases where, for example, the granting of a compulsory license has not remedied the lack of exploitation of the patent)". NAFTA also contains a more extensive application of the national treatment principle, higher standards of copyright protection and more restrictive provisions on compulsory licensing (Drahos, 2001).

35 In relation to intellectual property rights, the United States is going much farther than NAFTA in its demands in subsequent bilateral and regional agreements (Shadlen, 2005b).

36 On the other hand, the United States has lost importance as a source of Mexican imports. The share of imports from the United States in Mexico's total imports fell from 71.5 per cent in 1990–1995 to 59.4 per cent in 2000–2005. This may be a sign of the loss of competitiveness of United States exports. On the other hand, trade with Canada has remained marginal for Mexico.

37 Pacheco-López and Thirlwall (2004) also discuss how Mexico's economic development as a result of liberalization has been limited because of the balance-of-payments constraint.

38 See UNCTAD *Handbook of Statistics 2005*, table 4.2E.

39 The change in the definition of FDI in 1994 does not permit an accurate comparison between pre- and post-NAFTA periods (Pacheco-López, 2005).

40 For a more detailed analysis of the development of international production networks and its implications for developing countries, including Mexico, see *TDR 2002*. A case study of the Mexican automobile sector, the problem of its strong dependence on inputs from the United States and its current policy challenges is discussed in Mortimore and Barron (2005).

41 These authors highlight the high concentration of export-oriented manufacturing in a few industries. High concentration is also found at the level of firms, with no more than 300 firms accounting for the bulk of Mexico's manufactured exports. Pacheco-López (2005) also reports that competition from the TNCs, along with the high import content of their export-oriented production, has increasingly driven domestic firms out of business.

42 *TDR 2003* (box 5.1) presents a more detailed examination of Mexico's industrial structure for the period 1980–1998. It shows that in some sectors such as clothing, exports grew rapidly while domestic value added fell; in transport equipment, non-electrical machinery, electrical machinery and professional and scientific equipment, exports grew faster than value added. By contrast, in some other sectors that are not integrated into international production networks, growth in value added was strong but export performance was below average.

43 See also *TDR 2003*: 105–106; Moreno-Brid, Rivas Valdivia and Santamaría, 2005; and Cimoli et al., 2006.

44 Moreover, Moreno-Brid, Rivas Valdivia and Santamaría (2005) report that banking credit for productive activities as a proportion of GDP shrank by more than 15 per cent between 1996 and 2005.

45 At an average annual rate of 3 per cent a year between 1990 and 1999 (Sáinz, 2006).

46 Palma (2005) shows that even in the automobile sector, which was the most successful in terms of productivity, wages have stagnated.

47 For international comparison purposes, ECLAC figures on poverty differ from government figures, which were 52.5 per cent in 1994, declining to 47 per cent in 2005 (See Secretaría de Desarrollo Social, at: www.sedesol.gob.mx/).

48 Hanson (2003) discusses in some detail the increasing regional wage differences, as well as the rising inequality of wages between skilled and non-skilled workers. He also reports that there is little evidence of convergence in wages between Mexico and the United States.

49 Data on migration obtained from Giorguli, Gaspar and Leite, 2006; Hoefer, Rytina and Campbell, 2006; and United States Department of Homeland Security, *Yearbook of Immigration Statistics: 2006*, tables, at: www.dhs.gov/ximgtn/statistics/publications/LPR06.shtm. Data on remittances obtained from World Bank, *Remittances* database at: www.worldbank.org/.

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