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Conclusions

JEFFREY J. SCHOTT

The launch of free trade negotiations between the United States and Colombia, Ecuador, and Peru in May 2004 created important opportunities and challenges for each of the participating countries. This chapter summarizes some of the most salient aspects of the initiative.

Considering the modest level of trade and investment between the partner countries and the generally open access to the US market afforded under the Andean Trade Preference Act (ATPA), it is not surprising that the welfare gains from a prospective free trade agreement—as detailed in the modeling results reported in chapter 4—are relatively small. The United States can expect significant increases in exports to the region from a small base and positive, albeit minimal, GDP gains in relation to the huge size of the US market. In contrast, aggregate welfare gains for Colombia should exceed 0.4 percent of GDP due to both large terms of trade effects and improved efficiency in its domestic production. Since the models deployed omit key sectors such as services and give short shrift to dynamic gains generated by enhanced competition and increased investment in the economy due to changes in the policy regime, these results undoubtedly underestimate the potential gains for both sides.

That said, the economic impact of an FTA will vary depending on the scope of reforms generated by other bilateral, regional, and multilateral trade initiatives in which the United States and Andean countries also participate. Indeed, the applied general equilibrium model results in chapter 4 indicate that Colombia's welfare gains are cut in half if one simulates the bilateral FTA with the United States together with the other FTAs that the

Jeffrey J. Schott is a senior fellow at the Institute for International Economics.

United States has signed or is currently negotiating. Completion of the Free Trade Area of the Americas (FTAA) would further dilute Colombia's advantage in the US market compared to its South American neighbors; so too would the results of the Doha Round of multilateral trade negotiations if those talks produce significant cuts in tariffs applied on a most favored nation basis that reduce the value of all FTA tariff preferences.

To achieve the gains promised by the economic models requires the foresight to offer "concessions" to the other trading partners. An open secret of trade policy is that the bulk of the welfare gains that can be garnered in a trade negotiation generally derive from reforms of one's own restrictions on trade and investment in goods and services. Getting your trading partner to "pay" for this self-promotion is often a prerequisite for domestic political support for the desired policy changes. That's why trade negotiators describe their final outputs as "win-win" propositions.

For the United States, with low most favored nation trade barriers and extensive tariff preferences accorded to Colombia and many other developing countries, the changes required by FTAs are limited. However, the ATPA expires at the end of 2006; an FTA would turn those unilateral and time-limited preferences into permanent and contractual obligations of the United States. In addition, the few remaining US barriers protect sectors (e.g., apparel, sugar) where trade liberalization could create substantial new export opportunities for developing countries. Selling such policy reforms to the US Congress has become increasingly difficult, as witnessed by the strident debate and razor-thin margin of passage of the Central American Free Trade Agreement–Dominican Republic (CAFTA-DR).

US officials have drawn two clear lessons from the CAFTA-DR experience for ongoing and prospective free trade agreements: first, future trade deals must be at least as comprehensive as CAFTA-DR in terms of coverage and perhaps go even farther with respect to labor and environmental provisions; and second, US negotiators need to be circumspect in putting forward proposals for textile, apparel, and sugar reforms. Of these products, the sugar industry has been the most resistant to trade liberalization, and it is thus notable that US negotiators agreed to increase the sugar quota for Colombia to 75,000 metric tons (plus a small annual growth factor). In the US FTA with Australia, sugar was fully exempted from the free trade regime, and CAFTA-DR called for only a very modest expansion of US sugar quotas, which the Congress approved only grudgingly. Additional liberalization—whether via an FTA with the Andean countries, a Doha Round accord, or implementation of existing North American Free Trade Agreement (NAFTA) commitments to Mexico—would likely render untenable the current US sugar programs and thus require extensive reform of US sugar policy. Such reform would make sense from an economic, environmental, and health policy perspective; to date, however, Congress has not regarded these advantages as compelling enough to override the demands of special interest politics.

For Colombia, an FTA will require more substantial changes in current policies that protect manufacturing, farming, and services. The pact should, however, afford reasonable transition periods before the free trade obligations are fully implemented to allow an orderly adjustment for workers and firms. The agricultural sector will undoubtedly pose the most vexing adjustment problems, particularly when the FTA provisions are coupled with ongoing efforts to promote alternative crops to the lucrative but illegal drug trade. Colombian farmers continue to oppose lowering trade barriers to temperate agricultural imports from the United States, and they charge such products benefit from extensive government subsidies. The availability of safeguard measures will be important; so, too, will adjustment programs to help restructure the rural economy and facilitate new investment, particularly in basic infrastructure (as has been offered to Central American countries through the Millennium Challenge Corporation and other bilateral assistance programs).

In addition, the CAFTA-DR ratification debate in the United States underscored the salience and sensitivity of labor rights and protections in partner countries. As noted in chapter 6, this issue could be even more contentious for the Andean countries. Developing a credible program of labor initiatives under the complementary labor cooperation agreement, including the provision of adequate financial resources for labor programs and their implementation and enforcement, should be a high priority. Indeed, it may be a prerequisite to closing the overall trade deal.

Colombia's special relationship with the United States, and in particular its alliance in the war against drug trafficking, provides some advantages vis-à-vis other US trading partners. As noted in chapter 1, that alliance was a crucial consideration in launching trade talks in 2004 and will be highly influential in congressional consideration of the final agreement. As such, if the terms of the prospective pact are comparable to other agreements ratified by the Congress, the special relationship should make the ratification debate less contentious than the strident and sharply divided vote on CAFTA-DR in the summer of 2005. But, again, such an outcome depends importantly on how labor problems in Colombia are addressed both in the FTA and in domestic regulation and enforcement.

The United States has a vested interest in Colombia's economic development and in its success in the war against drugs and in ending the prolonged armed insurrection in the country. These foreign policy objectives are integrally linked with progress on the economic front; indeed, they are what makes the US-Colombia relationship "special" and a key reason why Colombia rose to the top of the FTA queue with the United States. Nonetheless, Colombia's special relationship does not translate into exemptions from the comprehensive reforms required of other US trade agreement partners. Given the CAFTA-DR aftershocks, it is clear that Colombia should not expect a payoff in terms of extraordinary trade concessions on import-sensitive products.

At the same time, however, in light of US geopolitical objectives in an FTA with Colombia, US officials probably will continue and possibly expand current levels of financial, technical, and military assistance to reinforce Colombia's economic development and security needs. In other words, because of the special relationship, the United States may be more inclined to support more capacity-building initiatives than provided to other FTA partners (with the exception of Mexico). In particular, the United States should be willing to contribute to investment in economic infrastructure and channels for microfinance for small enterprises in both urban and rural areas in Colombia. Such programs could be integrated into the overall package of agreements associated with the trade pact, though on a more discrete scale than the North American Development Bank that was appended to the NAFTA primarily to provide financial assistance to border communities affected by the trade pact.

In short, an FTA will demand much more of Colombia than of the United States—just as it has of all the other FTA partners with which the United States has negotiated trade pacts. Most of the changes will involve domestic policies that Colombia would need to restructure in any event as it strives to keep pace with foreign competition at home and in its key export markets. An FTA provides additional impetus to do so by offering both economic and political benefits in the form of increased bilateral trade and investment, which in turn will create a stronger foundation for the overall bilateral relationship between Colombia and the United States.

Using the Free Trade Agreement to Promote Colombian Economic Development

Free trade agreements do not provide a ticket to prosperity. Trade reforms should be seen as an integral, albeit minor, part of a broader development strategy. If implemented in conjunction with domestic economic reforms, FTAs can give a powerful boost to economic growth. If Colombia is to use its FTA with the United States most effectively, it would do well to heed the lessons derived from past experience with such agreements.

First, FTAs create opportunities; they do not guarantee sales. Firms need to be able to take advantage of the market opening by producing goods or services of sufficient quality and price to garner sales. Tax and regulatory policies that blunt productivity and impose obstacles to investment will leave unfulfilled the economic potential of trade agreements.

Second, FTA preferences offer only temporary advantage. The value of the negotiated tariff preferences declines over time due to most favored nation trade liberalization negotiated in the World Trade Organization (WTO) and to the granting of similar preferences in other preferential trading arrangements. So it is critical to use the transition period during which trade liberalization is phased in to undertake structural adjustments that enable firms and workers to meet the challenges from foreign competitors in the home and third-country markets. This is an area where Mexico has fallen short, particularly in the agricultural sector. Although Mexico's agrarian reforms predated the signing of NAFTA and sensitive farm products were given lengthy periods to phase in NAFTA liberalization, the Mexican government did very little to revamp its farm programs while the protection remained intact.

Third, an FTA should be designed primarily to spur competition and investment in the economy. Its major benefit is not the extension of trade preferences but rather its role as an "insurance policy" against new protectionism at home and abroad, because the contractual obligations of the trade pact effectively raise the cost of policy reversals. This insurance applies both to domestic policies and to the foreign market access commitments secured in the trade pact. In essence, an FTA locks in policy reforms and in so doing contributes to a more stable and attractive environment for investment. If the overall policy mix is right, an FTA could help raise Colombia's profile among international investors.

Fourth, FTAs can help propel integration among the partner countries negotiating with the United States. One of the major achievements of CAFTA-DR was spurring regional integration among the Central American countries, in addition to deepening trade and investment ties with the United States. By unifying formerly fragmented markets, CAFTA-DR also is helping to spur the physical integration of the region by making more viable investment in transport, energy, and telecommunications infrastructure that facilitates trade in goods and services within Central America. While the Andean countries already have worked out an incomplete customs union, the development of common obligations with the United States in an FTA could help harmonize areas of policy friction within the Andean Community (at least among those members who partner with the United States) and spur investment in a similar fashion.

Unfortunately, political differences among the Andean countries seem to be working in the opposite direction. Venezuela's notification in April 2006 that it intends to withdraw from the Andean Community demonstrated starkly how difficult it has been, and will be, for the Andean neighbors to work together for their mutual benefit. The main exceptions to this dire forecast may be Colombia and Peru, which have both instituted market-oriented policies to address the challenges of global competition in general and free trade with the United States in particular.

Finally, an FTA does not ensure that the gains from trade will spread evenly throughout the country. Trade liberalization generates winners and losers, and often there is a wide gap between those that benefit from new trade and investment opportunities and those that are unable to compete in a more competitive environment. In Mexico, the income gap between northern and southern states has widened substantially since NAFTA entered into force, and some components of the agricultural economy have suffered. Several factors contributed to such skewed growth, but inadequate investment—particularly in economic infrastructure—has been the main culprit (Hufbauer and Schott 2005). Due to tight fiscal and monetary policies required by the initial response to the peso crisis in 1995 and political gridlock that has prevented the passage of needed tax and energy reforms, Mexico has not invested enough in physical and human capital to take full advantage of the new opportunities created by NAFTA.

In sum, an FTA can succeed in promoting economic growth if the trade bargain catalyzes economic reforms in each partner country. The challenge for policymakers is to create a policy environment conducive to trade and investment that will open new opportunities for firms and workers, while providing a more reliable social safety net to facilitate the adjustment of those workers and their communities that fall behind in the new competitive environment. For Colombia, this challenge is complicated by the production and trafficking of illicit drugs that have such a distorting impact on its rural economy. Helping its partner overcome this problem is, in essence, the main challenge and the ultimate prize that can be achieved for the United States as well.

Implications of Andean Free Trade Agreements for Broader Hemispheric Integration

The US-Colombia FTA and the US-Peru Trade Promotion Agreement are highly similar but separate pacts. They were designed to be implemented as stand-alone initiatives but also to be agglomerated into a broader free trade regime linking countries in North and South America.

The original vision of hemispheric trade integration, set forth at the Miami Summit of the Americas in December 1994, was to negotiate the FTAA. As mandated by the summit leaders, the FTAA was to be a self-contained negotiation among the 34 democratic countries in the hemisphere. FTAA negotiations formally began after the Santiago Summit of the Americas in April 1998. However, the negotiations soon bogged down and have been moribund since the November 2003 meeting of Western Hemisphere trade ministers in Miami. The deadline for concluding the talks passed virtually unnoticed in January 2005. The cochairs of the negotiations, the United States and Brazil, have focused efforts instead on the Doha Round in the WTO and on other bilateral FTAs.

Can the US-Colombia and US-Peru pacts restore momentum toward the creation of a broader free trade regime in the Americas? At present, the signs are not positive. First, the pacts have provoked the fragmentation rather than deeper integration of the Andean Community. Venezuela announced its intention in April 2006 to withdraw from the Andean Community in protest over the deepening ties with the United States. Trade talks with Ecuador lagged those with Colombia and Peru and were at least temporarily suspended in May 2006 due to energy sector investment problems. Bolivia has been a casual observer of the FTA process, but as a result of policy changes undertaken by the new administration of President Evo Morales, the country has dimmed prospects for a future trade deal with the United States. The Andean Community never had a fully integrated market, and intraregional trade is now under increasing stress.

Second, both the Colombian and Peruvian pacts face domestic opposition. In Colombia, the FTA has generated sharp criticism, particularly from agricultural interests, but is likely to be ratified. In Peru, the administration of President Alejandro Toledo ratified the pact before it left office in late July, with muted support from incoming president, Alan Garcia, who had been critical of the agreement during the election campaign. Ensuring that the new Peruvian government fully implements the pact will be a central focus of US legislators when they address implementing legislation in the second half of 2006, in addition to concerns about abusive labor practices raised by Democrats in the House of Representatives.[1] Since congressional notification of the US-Colombia FTA was delayed throughout the spring of 2006, it is unlikely that the US Congress will pursue the ratification process until 2007. In the interim, Congress should extend the ATPA preferences to avoid disruptions in Andean exports to the United States that could occur if ATPA benefits expire.

Third, many Latin American countries seem distracted by pressing economic and political problems at home; all face the challenge of adjusting to rapidly changing conditions in the global economy generated by technological innovation and by the emergence of the Chinese trading juggernaut. Some have denounced the FTAA process; others have openly questioned its continued viability or desirability.

However, like Mark Twain reading his obituary, news of the death of the FTAA may be premature. Although the talks have drifted, concrete trade negotiations have advanced among subsets of FTAA participants. There already are numerous FTAs linking countries in North and South America, FTAs or customs unions among Latin American neighbors, and a variety of "partial scope" trade accords that grant sector-specific benefits to bilateral trading partners. To be sure, except for NAFTA, most of these accords involve small volumes of trade, but this is not necessarily bad for prospects for an FTAA.

US officials have deliberately moved forward with bilateral FTAs with a number of Latin American and Caribbean countries, challenging Brazil and its Southern Cone Common Market (Mercosur) partners to catch up when they are ready to negotiate actively in the FTAA. CAFTA-DR and pacts with Chile, Colombia, Peru, and possibly Panama—along with deepening integration in the NAFTA region—are designed to maintain momentum and establish negotiating precedents for the broader FTAA ex-

1. See *Inside US Trade*, March 31, 2006.

ercise. In addition, US unilateral tariff preferences have been extended through September 2008 under the Caribbean Basin Trade Partnership Act of 2000 (CBTPA) for most Caribbean exports not covered by the original Caribbean Basin Initiative (CBI).[2] What remains that is not subject to free trade commitments is mainly US trade with Mercosur and with Venezuela and Bolivia.

If the bilateral and subregional accords accelerate the pace of economic reform, they will contribute importantly over time to the ability and willingness of Latin American and Caribbean countries to undertake the reciprocal obligations of the broader hemispheric pact. Indeed, that is one of the advantages that the Colombia and Peru pacts bring to the broader hemispheric trade initiative.

Even if not all of the original 34 countries participate, revival of the FTAA process is possible if driven by two separate events: the Doha Round of multilateral trade negotiations and the evolution of new Asia-Pacific trade linkages. First, if the Doha Round succeeds, commitments to reduce agricultural subsidies will remove a major substantive barrier to trade talks between the United States and Mercosur. Uruguay is already pressing its Mercosur partners to move in this direction, and the others could follow suit if the impasse over agricultural reforms is broken. On the other hand, if the Doha Round fails, or concludes with a minimalist package of trade reforms, then the Mercosur countries may turn back to the hemispheric talks with even greater ardor—since they will be at a distinct disadvantage vis-à-vis most of the countries on the west coast of South America, plus Central America and the Caribbean, that already have preferential access to the US market.

Second, several Latin American countries are forging new trade pacts with East Asian countries. Chile has concluded deals with China and Korea; Mexico has an FTA with Japan and is talking about closer trade ties with Korea; and Peru is negotiating with Thailand. To take advantage of these new opportunities and to encourage the inflow of new foreign direct investment in their economies, these countries will need to pursue the types of trade and regulatory reforms required by US-style free trade agreements. This should build support for cumulating the gains from individual FTAs into an integrated regional free trade regime.

Such considerations could well drive the revival of FTAA talks, led by Colombia, Peru, Chile, and other US trading partners that already have concluded bilateral deals with their principal trading partners in the hemisphere. The allure of such an alliance may prove attractive for Brazil and Argentina as well.

2. The CBTPA provides "NAFTA parity" for products (mostly textiles and apparel) excluded from the Caribbean Basin Economic Recovery Expansion Act of 1990, known as CBI II. Unlike the CBI preferences that have no termination date, the supplementary benefits under CBTPA must comply with NAFTA rules of origin and expire on September 30, 2008.