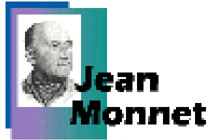

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The Free Trade Area of the Americas: Current Status and Prospects

– **Jeffrey J. Schott**

Jean Monnet/Robert Schuman Paper Series
Vol.5 No. 15
July 2005

This publication is sponsored by the EU Commission.

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The Free Trade Area of the Americas: Current Status and Prospects

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The Free Trade Area of the Americas: Current Status and Prospects

Introduction

Trade negotiations progress at a deliberate pace. When the task is to negotiate a free trade agreement (FTA), the process can become even more tentative. Officials must balance the interests of participating countries in terms of coverage, depth of reform, and time period to implement or phase-in the terms of the agreement. Because the objective of FTA negotiations is to *eliminate* trade barriers between the signatory countries, the politics of FTA negotiations can be more difficult to manage than global trade deals (where most-favored nation (MFN) liberalization can be limited or avoided entirely for import-sensitive products).[1] Often, the negotiating timetable must be extended to resolve unexpected problems or to accommodate the domestic political calendars.

Thus, it is not surprisingly that the negotiation of a Free Trade Area of the Americas (FTAA), comprising 34 democratic countries in the Western Hemisphere, has struggled to advance over the past decade. The Summit of the Americas in Miami in December 1994 provided the original mandate for an FTAA that would progressively eliminate barriers to trade and investment in the hemisphere and targeted the completion of the negotiations no later than January 2005. After several years of consultations and preparations, the trade talks were finally launched after the Santiago Summit in April 1998. Seven years later, the original deadline for concluding the trade deal has passed and negotiations remain at an impasse. With each passing month of inactivity, doubts grow about the viability of the exercise.

By any standard, the FTAA is the most ambitious free trade initiative of the postwar trading system. The 34 FTAA participants span the world's richest and poorest, and largest and smallest, countries. Never before have countries of such widely diverse size and level of development joined together to negotiate a *reciprocal* trade pact. Crafting a free trade pact among this diverse group of countries was never going to be easy. The task has been further complicated by the financial crises and political turmoil that beset many Latin American participants since the FTAA talks began, the US economic downturn in 2001–02, and the new security imperatives of the post-9/11 world.

This short paper examines the current status of the FTAA negotiations and posits what needs to be done to get the talks back on track. To better understand the current negotiating stakes, I first briefly discuss the historical factors that precipitated the hemisphere-wide trade initiative.

[1] In multilateral negotiations—such as those that have taken place in the General Agreement on Tariffs and Trade (GATT) and in the World Trade Organization (WTO) over the past 55 years—negotiators accept incremental reforms that leave many trade barriers intact; this approach allows officials flexibility to manage the adjustment to freer trade and to accommodate protectionist lobbies at home.

Why Did Countries Want an FTAA?

Why did the countries of Latin America and the Caribbean (LAC) reverse decades of antipathy to formal trade ties with the United States and support—and in some cases actively lobby for--a free trade deal with the world's industrial superpower? The answer is complex and requires more analysis than can be devoted in this short paper. But in most cases, the policy reversal reflected a sea change in national economic policies and development strategies caused by the failure of the import-substitution model of development of the 1960s and 1970s, the collapse of debt finance in the wake of the Latin American debt crisis of the 1980s, and the inexorable competitive pressures emanating from the advance of globalization.

Why did the United States promote the idea of an FTAA with the LAC region? Visions of a hemisphere-wide free trade zone were expounded by Ronald Reagan a generation ago, but were shunted aside during the lost decade of the 1980s as debt problems, high levels of trade protection, civil strife, corruption, and autocratic rule in the LAC region burdened US-Latin American relations.

While Ronald Reagan may have put the vision of hemispheric free trade into words, the leaders of Mexico deserve credit for taking decisions that provoked other LAC countries to embrace trade talks with the United States. Mexican President Miguel de la Madrid turned to economic reform in 1985 essentially because there were no other viable alternatives. Carlos Salinas followed and accelerated the reform program during his term in office. His pivotal decision to request an FTA with the United States in early 1990 can be seen as the first concrete step toward a hemispheric trade pact. Instead of slowing down the reform process to "digest" the substantial economic adjustments incurred in the 1980s, Salinas used the prospect of the FTA to accelerate the pace of economic change within Mexico and to encourage inflows of foreign direct investment (FDI). In fact, the mere announcement effect of FTA talks elicited significant new commitments of FDI in Mexico in anticipation of the new trade regime with the United States.

When Mexico and the United States announced the launch of FTA negotiations in June 1990, which evolved into the NAFTA when Canada joined the talks several months later, other countries in the LAC region faced a new competitive challenge for market share in and FDI from the United States. The purpose of NAFTA for Mexico was to complement ongoing domestic reforms and create new trade and investment opportunities within the Mexican economy—some at the expense of neighboring countries. The prospective NAFTA preferences posed a real competitive threat to countries participating in the Caribbean Basin Initiative (CBI) and in the Andean Trade Preferences Act (ATPA). Those countries either had to emulate the Mexican (and Chilean) reforms—following a strategy of competitive liberalization—or risk losing trade and investment to countries offering a more hospitable business climate.

The United States could not say "no" to the audacious Mexican proposal, but US officials were cognizant of the potential adverse effects the NAFTA could have on nascent economic and political reform in the LAC region. Accordingly, President

George H. W. Bush announced the "Enterprise for the Americas Initiative" (EAI) just a few weeks after the US-Mexico decision to develop an FTA. The EAI had three main pillars: trade, finance, and debt. It was designed to support the new commitment to democracy and market-oriented reforms throughout the LAC region by expanding regional trade and investment and helping to reduce national debt burdens (by augmenting the Brady Plan). Trade was the focal point of the EAI, with the ultimate goal of creating a Western Hemisphere FTA.[2]

The EAI soon was overshadowed by ongoing negotiations of the NAFTA and the Uruguay Round, and subordinated to new initiatives involving the rapidly growing nations of the Asia Pacific Economic Cooperation (APEC) forum. The onset of annual Summit meetings of APEC leaders, starting in Seattle in November 1993, posed a sharp contrast to US relations with the LAC region. To its credit, the Clinton administration subsequently proposed a new Summit of the Americas to parallel the APEC process. The resulting meeting in Miami in December 1994 echoed the APEC commitment to free trade and investment in the region by 2010/2020 issued three weeks earlier with the mandate to negotiate a FTAA within a decade.[3]

What is the FTAA Really About?

The FTAA was never meant to unite the economies of the Western Hemisphere; it merely sought to eliminate barriers to trade and investment among participating countries. To be sure, some officials projected a broader vision of the FTAA, and sought to borrow elements of the European integration model for the FTAA process, particularly the use of regional aids to promote growth in less-developed countries. Small developing economies have called for special FTAA funds to transfer resources from North America to poorer parts of the LAC region akin to the regional development grants funded by the richer, northern European countries as inducements to get new members to join the European Community. Similarly, Mexican leaders also have sought increased NADBank financing for public infrastructure projects. None of these countries, however, buys into the political side of the European bargain—the ceding of sovereignty to supra-regional bodies—since in the Western Hemisphere context that would translate into US hegemony over the LAC region.[4]

[2] Gary Clyde Hufbauer and Jeffrey J. Schott, *North American Free Trade: Issues and Recommendations* (Washington: Institute for International Economics, 2002).

[3] For a comparative analysis of the APEC and Western Hemisphere trade initiatives, see Richard Feinberg, "Comparing Regional Integration in Non-Identical Twins: APEC and the FTAA." *Integration & Trade* 4, no. 10, Buenos Aires: INTAL (January-April 2000).

[4] Postwar European integration has both political and economic dimensions. Countries have been willing to cede sovereignty to supra-regional authorities as part of the process of creating a more politically unified Europe. Part of the glue of the alliance was transfers mandated by the common agricultural policy. In addition, new entrants received regional aids to assist in the adjustment to the common European regime. This is obviously only a caricature of the process of European integration. However, it suffices to make the simple point that the European experience has had much broader economic and political goals than those sought in the FTAA.

For that reason, the FTAA always had a more traditional and discrete trade objective: to remove barriers to trade in goods and services between the countries of North and South America. It is not a surrogate or a channel for development aid; however, the trade and regulatory reforms implemented in response to FTAA provisions can and should be important components of national development strategies. Indeed, what distinguishes the US-LAC trade initiatives from many ventures between other developed and developing countries around the globe is the recognition of the developing countries that they need to adjust their domestic policies both to attract foreign investment and to promote competition in the home market. Without sustained economic reform—abetted by FTAs but primarily driven by domestic development imperatives—trade pacts will not generate the expected gains to trade and economic growth.

As mandated by Summit leaders, the FTAA is a self-contained negotiation among the 34 democratic countries in the hemisphere. As a practical matter, however, these countries already are moving toward free trade at different speeds with different countries in the region. There already are numerous FTAs linking countries in North and South America, FTAs or customs unions among LAC neighbors, and a variety of "partial scope" trade accords that grant sector specific benefits to bilateral trading partners. Except for the NAFTA, most of these accords involve small volumes of trade: for example, intra-Mercosur exports in 2003 totaled only $12.7 billion or 12 percent of global exports of the four countries (down from 25 percent in 1999). By contrast, intra-NAFTA exports were valued at about $609 billion in 2003, and accounted for 57 percent of total exports of the three countries that year—and almost 80 percent of total trade between the Western Hemisphere countries.[5]

The United States accounts for much of hemispheric trade and large shares of the total trade of the Central American and Andean countries. Moreover, much of that trade is or will be liberalized under existing and prospective FTAs. The United States already has implemented FTAs with Canada, Chile, and Mexico, has signed but not ratified pacts with the five Central American countries and the Dominican Republic; and is currently negotiating FTAs with Colombia, Ecuador, Panama, and Peru. What's left is mainly US-Caricom and US-Mercosur trade.

Why then bother with a FTAA? The short answer is that an FTAA would yield both economic and foreign policy benefits. First, the FTAA would have beneficial effects on the conduct of overall economic policy in and economic relations among the participating countries. Second, the FTAA would link the major economies of North and South America, whose bilateral trade—as projected by gravity models—could expand two or three-fold in response to FTA-type reforms.[6]

Many LAC countries already have open access to the US market for most merchandise products because of CBI and ATPA preferences, or because US MFN tariffs are zero or very low. Of course, there are a few notable exceptions, mostly involving

[5] Inter-American Development Bank (IDB). *Integration and Trade in the Americas: A Preliminary Estimate of 2004 Trade*, Periodic Note, December 2004 (Washington: Inter-American Development Bank, 2004).

[6] For more detailed discussion of FTAA benefits, see Jeffrey J. Schott, *Prospects for Free Trade in the Americas* (Washington: Institute for International Economics, 2001).

agricultural goods; these products have been immune to deep MFN reforms and often are excluded from FTA or unilateral trade preferences. For many countries, the value of their bilateral FTAs and the FTAA is more secure access to the US market since these trade pacts turn their unilateral preferences into contractual obligations. By "locking in" open access to markets, free trade pacts help reduce uncertainty about the future course of trade and regulatory policies and thus facilitate business planning and investment. For many developing countries, this benefit is key to the success of their investment-led development strategies.

The FTAA initiative does cover one big gap in the free trade matrix of the Western Hemisphere. The largest countries of North and South America—which also are those with the lowest trade openness ratios—engage in free trade talks with each other only in the hemispheric context. Bilateral trade between the United States and Brazil is relatively small; two-way trade was $35 billion in 2004—by contrast, US-Mexico trade was valued at $266 billion.

Compared to their peak in 1997, US merchandise exports to Brazil in 2003 were 33 percent *lower* due to the economic crises in Brazil (and subsequently Argentina). By contrast, US imports from Brazil have continued to grow markedly and were 86 percent *higher* in 2003 than in 1997.[7] Bilateral trade in services also has grown rapidly; US services exports have more than doubled since 1992 and imports have almost tripled.

Gravity models indicate a large US-Brazil bilateral trade deficiency; in other words, the United States and Brazil trade less with each other than is expected given the magnitude of the two economies and the distance between them. If the United States and Brazil had access to each other's market comparable to that existing in the NAFTA region (adjusted for market size, per capita income, and geography), US-Brazil trade could quickly double (or more). Of course, to achieve such results, the main barriers to bilateral trade would need to be liberalized.

In addition to trade gains, the United States has a sizeable investment stake in the Brazilian economy—and Brazil has an important interest in encouraging additional FDI from the United States and elsewhere. At yearend 2002, US holdings in Brazil were valued at $32 billion on a historical cost basis—though down from its peak of $39 billion in 2000. Part of this growth can be attributed to the participation of US firms in the privatization of Brazilian energy and telecommunications companies, but a significant share has been placed in manufacturing plants that serve both the large Brazilian market and other export markets. More than one third of US FDI in manufacturing in the LAC region is in Brazil.

[7] Compared to many US trading partners in the hemisphere, Brazil's trade linkages with the United States are relatively modest. In 2003, Brazil's leading trading partner was the European Union, which accounted for roughly one-quarter of total merchandise trade. Next came the United States, with almost 22 percent, the Mercosul countries with 9.4 percent (well down from pre-crisis levels in the late 1990s), and China with 5.5 percent (almost double its share from the previous year).

The United States and Brazil will continue to co-chair the FTAA talks for their duration. An FTAA deal will not get done unless the two countries bridge their differences and offer concrete new opportunities for their exporters and investors in each other's markets.

FTAA: Current Status

Bluntly put, the FTAA negotiations have been stuck in the mud since the Miami ministerial meeting of November 2003. At that time, soon after the failed WTO meeting in Cancun in September 2003 that had led to a breakdown in the Doha Round of multilateral trade negotiations, trade officials were under intense pressure "not to fail." While the substantive differences between the major protagonists were perhaps greater on the FTAA negotiating table than in the WTO talks, the co-chairs of the FTAA process—the United States and Brazil—produced a procedural compromise that allowed them to shake hands and promise to resume negotiating in early 2004. Looked at another way, trade ministers put a governor on the carburetor of the FTAA engine so that talks could sputter but not totally stall out.

The Miami Declaration adopted a new two-track approach to the FTAA. Ministers agreed to continue talks in all the existing negotiating groups, but offered countries greater flexibility to opt out of making commitments in sensitive areas. In essence, ministers "affirmed their commitment to a comprehensive and balanced FTAA" (paragraph 5), which includes "provisions in each of the [FTAA] negotiating areas" (paragraph 10). However, they also agreed that countries could take specific issues or products off the table, and some "countries may assume different levels of commitments" (paragraph 7).

This diplomatic double-speak basically accommodated two levels of negotiation: a core FTAA in which countries could exclude sensitive issues, and supplementary accords by a subset of FTAA participants that covered "FTAA-plus" commitments—otherwise referred to as "plurilateral" agreements that only obligate those countries that sign the specific pact. Thus, if Brazil and others did not want to negotiate on investment and intellectual property issues, they could opt out of a hemispheric accord in those areas while the United States and others could adopt a more comprehensive accord among a subset of FTAA participants (probably the same countries that already have signed FTAs with the United States).

The value of the plurilateral approach is unclear, since there is little "additionality" if the pacts exclude important LAC countries like Brazil and basically replicate existing obligations in bilateral FTAs involving the United States. At best, plurilateral pacts would harmonize the terms of existing FTAs inter alia by augmenting Canadian obligations in NAFTA and unraveling politically sensitive compromises on FTA origin rules for textiles, clothing, and agricultural products. Such a result is highly unlikely. A more limited outcome would not seem sufficient to justify the political cost/risk of going back to Congress for another vote on these pacts.

The plurilateral option was introduced to accommodate the incremental development of an FTAA through a series of iterative negotiations. In so doing, however, it has made it more difficult to take the first step.

To many observers, the Miami mandate seemed to walk away from the comprehensive trade accord that hemispheric leaders promised at the Summit of the Americas in 1994, and had reiterated at their subsequent reunions in Santiago (1998) and Quebec City (2001). Some countries took the Miami mandate as license to try to remove entire areas from the talks—leading some observers to derisively label the potential outcome "FTAA-lite". The Brazilians certainly thought that they had pared down the negotiating agenda to core issues that need not include subjects sensitive to them—particularly, investment and intellectual property rights (IPRs)—but such a result is not viable since the United States could not agree to liberalize its own border barriers to trade in the absence of reciprocal benefits for US traders and investors. If action on key trade and investment issues is deferred, will US or Brazilian officials be able to garner political support to reform longstanding barriers protecting farmers, manufacturers, and service providers?

Simply put, the Miami Declaration complicates the task of crafting a balanced package of concessions that negotiators can sell to their respective legislatures. It took pressure off the Brazilian negotiators by giving them an excuse for their minimalist position on so-called WTO-plus issues—i.e., those that go beyond the scope of existing WTO rights and obligations. For Brazil, the Miami decision seemed to condone a FTAA that simply removed traditional border barriers and did not require commitments on new issues like investment and competition policy. At the same time, it allowed US officials to defend inaction on US farm barriers because of lack of reciprocity from their Brazilian counterparts. An "Alphonse and Gaston" routine, without the French diplomatic flair!

As a practical matter, the Miami mandate could produce a meaningful result, but it probably won't. To succeed, the talks will have to produce concrete new opportunities for all countries, and particularly for the co-chairs in each other's market. That means Brazil must negotiate, for example, on services, government procurement, and intellectual property issues, and that the United States must be willing to improve market access for a number of Brazilian agricultural and processed agricultural products.

To date, US and Brazilian negotiators have been constrained by domestic political opposition to liberalization in areas of interest to the other:

- US officials are reluctant to discuss import-sensitive products like sugar (just ask the Australians!), and can't address Brazilian concerns about domestic farm subsidies in the FTAA (since such problems require reform commitments from all significant producers in the world market)—and won't be able to do so in the Doha Round until the Congress begins drafting the next US farm bill in 2006.

- Similarly, Brazil is reluctant to offer reforms in services, intellectual property rights, investment, and government procurement—not just because there is little on offer yet from the United States but, more importantly, because of domestic resistance to reform its own high border and regulatory barriers to trade.

As a result, FTAA talks have stalled. US policymakers have opted to move forward with bilateral FTAs with a number of Latin American and Caribbean countries, challenging Brazil and its Mercosur partners to catch up when they are ready to proceed in the FTAA. In essence, US officials have opted for a "surround Brazil" negotiating strategy rather than an "engage Brazil" approach.

Brazil has adopted a similar trade strategy; it has signed bare-bones FTAs with most of its LAC neighbors; product specific deals with Mexico and China; and is negotiating a free trade pact with the European Union. To date, the Brazilian strategy has scored political points in Latin America but made little progress in advancing Brazilian export interests in the major industrial markets.

The Miami mandate does not preclude the possibility of a comprehensive free trade accord among all 34 countries. Unless the co-chairs of the negotiations work more closely together, however, the likelihood is that the ministerial directive will lead to a "hollow core" agreement that deserves the deleterious banner of "FTAA-lite".

FTAA: What Should be Done?

In less than two years, US officials will lose their ability to invoke expedited legislative procedures to implement international trade agreements under the current trade promotion authority (TPA)—assuming Congress does not veto by June 30, 2005 the President's request to invoke the automatic two-year extension of TPA that is already provided in the legislation. It is highly unlikely that US officials would proceed with the FTAA in the absence of TPA or a similar congressional mandate to liberalize sensitive US trade barriers. Negotiators thus need to resume work quickly.

Some countries may believe that the time constraints on the FTAA negotiations put them in a good tactical position—since if time is short, then the FTAA package will perforce include only those issues on which agreement is relatively simple. It is entirely conceivable that the negotiations will end with a whimper—producing a framework for future efforts at substantive reforms. While such a result may appease diplomatic objectives, it would fail to promote new trade and investment opportunities. So what should be done?

First, political leaders need to reiterate their objective of achieving free trade in the hemisphere; all FTAA participants except Venezuela have done so in past summits and should recommit to finish talks by the first quarter of 2007. President Bush recently voiced his determination to follow through with the Summit of the Americas commitment at the NAFTA leaders meeting in Waco, Texas; President Lula da Silva and other Latin

American leaders should do so as well. This political commitment should be embodied in the declaration of the next Summit of the Americas in Argentina in November 2005.

Second, trade ministers need to update the Miami mandate to reflect recent events, including the progress on agriculture and other issues in the Doha Round of WTO negotiations. The long-delayed ministerial meeting to be hosted by Brazil should be convened by mid-2005 to revive talks in all the negotiating groups, including agriculture. The WTO framework agreed on August 1, 2004 in Geneva includes a firm commitment to eliminate agricultural export subsidies and to substantially reduce domestic support and border barriers to trade in farm products. Many of the objectives of the hemispheric pact in this sector will thus be implemented on an MFN basis once the Doha Round accords are ratified. FTAA negotiators can thus focus almost exclusively on market access problems involving specific products traded between Western Hemisphere countries.

What could be achieved? The essence of an FTAA accord should be improved market access for goods and services. Contrary to some comments from LAC officials, however, such a deal would have to include both liberalization of trade barriers and rulemaking reforms in areas such as services, investment, government procurement, and intellectual property rights. Indeed, improving access in services often requires domestic regulatory reforms and liberalization of investment restrictions. That said, the following gives an outline of what would be needed to put together a comprehensive package of market access reforms that would balance the needs of rich and poor countries alike.

Eliminating all industrial tariffs is likely to be the basis of an FTAA deal, with some balance struck between US farm trade reforms and enhanced access to Latin American procurement and services markets. The United States originally proposed in the Doha Round eliminating all industrial tariffs within 10 years; it should be able to do so on a faster timetable for its LAC partners. On the other hand, smaller and poorer economies--particularly those that rely on trade taxes for a large share of their current government revenues--should be afforded longer transition periods to implement the free trade obligations. However, those countries should not be granted exemptions from the FTAA disciplines, since such “charity” could deter needed adjustments in the domestic economy and discourage new investment in those countries.

On agriculture, tariffs should be phased out over a 10-year period with only limited exceptions, and reforms of non-tariff barriers should yield concrete market access benefits for other sensitive products (even if some protection is left intact in the form of tariff-rate quotas). Trade problems related to domestic subsidies cannot be resolved in the context of a regional agreement but could be substantially reduced in reforms likely to be accepted in the Doha Round.

Does this mean that the United States has to offer more quota for Brazilian sugar? Perhaps, but probably not. Such a concession would elicit a loud outcry—not just in the US Congress but also among other sugar-exporting nations in the region—against reforms that would threaten the viability of the existing US sugar program and thus their

sugar quota rents. The US sugar lobby already succeeded in exempting sugar reforms from an FTA with another competitive producer, Australia, and is lobbying to extend that precedent to new FTAs and to restructure other FTAs currently subject to Congressional review (e.g., the Central American FTA). While reform of the US sugar program would yield significant welfare gains for the US economy as a whole, including lower prices for US consumers, the politics of moving toward freer trade in sugar would be extremely difficult (as demonstrated in the FTA talks with Australia). At the same time, there is little appetite in Latin America for major liberalization of US sugar protection, since it would expose them to strong competition from Brazil and Australia and likely result in fewer sales and lower prices in the US market. The situation is not quite analogous to the Chinese dominance in textiles after the expiry of quotas under the Multi-Fibre Arrangement, but many countries in Latin America would lose market share in a more competitive sugar market in the United States.

At the end of the day, I suspect that Brazil will probably not demand much on sugar in deference to its foreign policy interests with its neighbors. This rosy conclusion requires, however, that some Brazilian processed agricultural export interests (e.g., ethanol) receive some concrete benefits from the deal--which will not be easy for US officials and will require a substantial quid pro quo in terms of services/IP reforms by Brazil.

Regarding procurement, FTAA negotiators should be able to agree on principles that provide transparency for public tenders and guidelines for open tendering. Over time, such rules should be complemented by a commitment to negotiate a list of entities whose purchases would be covered by these new obligations.

Regarding services, the preferred outcome would be agreement on a "negative list" that covers all services subject to FTAA obligations except those explicitly listed, but the more likely outcome will simply augment WTO commitments on a sector-by-sector basis, with particular emphasis on infrastructure services and e-commerce. US negotiators need to take home commitments for substantial new trading opportunities in services, because the support of the US services lobby is crucial for Congressional support of an FTAA package that includes controversial changes in US farm support and protection. Note, however, that services reforms also are critical to the economic development strategies of LAC countries. Inefficient financial and telecommunications sectors impose higher transactions costs on domestic industries and impede economic growth.

In sum, the key to success in the FTAA is agreement on a big package of market access reforms, including agriculture and other goods and services. That means both liberalization of existing tariffs and quotas plus reform of regulatory and administrative practices that effectively impede the ability to sell in foreign markets (including discriminatory standards and customs procedures, sector-specific investment reforms, and import relief policies--particularly safeguards). The United States and Brazil must lead

the way to a comprehensive package of trade reforms, or the FTAA will join a long line of failed integration initiatives in the hemisphere.*

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