CHILE AND THE U.S.:
Why A FTA?

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INTRODUCTION

During the last three decades, Chilean authorities have introduced a set of structural reforms that let the country to achieve impressive growth rates, macroeconomic stability and a substantial reduction in poverty during the 1990's. Between 1987 and 1997 Chile achieved an average annual growth rate of 7per cent. During the last decade, inflation fell from over 25 per cent in 1989 to around 3 per cent due to the independence of the Central Bank of Chile, the implementation of an inflation targeting monetary policy, relatively good coordination between fiscal and monetary authorities and a favorable external environment.[2] Social conditions have also much improved with high growth rates leading to the poverty line falling from more than 40 per cent of the population in 1988 under the poverty line, to under 20 per cent in 1998.

This impressive economic record was possible due to the economic stabilization policies during the second half of the 70's and the implementation of structural reforms, including trade reform, privatization of public enterprises, financial markets and pensions system reforms. In particular, trade reform played a central role in the development of the country because growth was led by an export-oriented strategy based on the exploitation of natural resources. Until 1973, a number of distortions were in place, in the form of price controls, multiple exchange rates and multiple tariffs, import quotas and permits. In 1974, the military government removed all quotas and permits. This was a drastic step in view of the fact that 50 per cent of the tariff positions required official approvals. By 1976, prohibitions were reduced from 187 to six, and import deposits were phased out. The authorities also rationalized the tariff structure, reducing maximum tariffs from 220per cent in June 1974 and achieving a uniform at 10 percent tariff by 1979 (Edwards and Dornbusch, 1994).

During the 1980's, Chile experienced various shocks, in particular the debt crisis. As a result the uniform tariff rate varied between 10 and 26 percent, but in the 1990's this

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[2] For more details about Chilean monetary policy in the 90's see Corbo (1999) and Corbo and Schmidt-Hebbel (2000).

rate stabilized again to 11per cent. [3] In 1998 the congress approved a law that reduced tariff rate by 1 per cent per year to reach 6 per cent by 2003.

In its first stages, as already mentioned, trade reforms consisted of the unilateral reduction of trade tariffs and making tariff rates uniform.[4] During the 1980's, Chile also started multilateral negotiations for trade liberalization under the GATT scheme (and later under the WTO) and in the 1990's, following world trends (EU, NAFTA, and MERCOSUR) it negotiated several bilateral and regional trade agreements. By using these three complementary approaches, Chilean authorities hoped to cover around 90 per cent of international trade before 2010.

This is the background of Chile as it enters into negotiating a free trade agreement (FTA) with the U.S. The aim of this paper is to discuss the characteristics, potential benefits and costs of this agreement, and the consequences for other trade negotiations in which Chile may be involved. The next section presents a discussion of the theory behind regional integration agreements (RIAs)[5], whilst the following section describes the characteristics of the FTA between Chile and the U.S. The paper closes with some conclusions and recommendations for maximizing the benefits from RIAs from a Chilean perspective.

THE THEORY BEHIND REGIONAL INTEGRATION AGREEMENTS

The growth in the number of regional integration agreements (RIAs) is one of the major developments of recent years. Most industrial and developing countries in the world are members of a RIA and more than one third of world trade takes place between countries that have such agreements.[6] In the last 10 years important changes in regional integration schemes have occurred. There are basically three major developments. First, is broadening the scope of integration as it was recognized that effective integration involved more than reducing tariffs and quotas. Second a surge of more outward looking agreements instead of the "closed regionalism" of the 1950's and 1960's. Third the proliferation of agreements between industrialized and developing countries (North-South RIAs).

These shifts in trends have occurred as globalization, due to new technologies, lower transport costs, and enhanced trade freedom, is changing the world we live in. I It is thus important to study the underlying factors of this surge of RIAs and their costs and benefits, both static and dynamic. The two major factors are principally political and economic. An understanding of the underlying factors and motivations will inform the policy choices regarding RIA that face a country, and also what with the approach should be vis a vis non-member countries.

[3] This is the official rate, but due to a number of RIAs, the effective tariff was lower.
[4] For more details about chilean trade policy see Edwards and Dornbusch, 1994.
[5] FTAs are a kind of RIAs.
[6] This figures increases to 59% if APEC is included.

POLITICAL REASONS BEHIND RIAS

Often political objectives outweigh economic objectives of RIAs. The political objectives are, mainly increasing national security, obtaining more bargaining power, locking in reforms and dealing with lobbies.

Intra-regional security has had an important role in the formation of many RIAs. For instance in the case of the EU or MERCOSUR, after periods of high political tensions, the authorities tried to reestablish confidence between neighboring countries through improving trade relations. The same is true in the case of relations between Germany and the rest of Western Europe and among South American countries after the demise of strong military governments. Similarly some Asian and Central American trade agreements were aimed at reducing such tensions (e.g. reducing tensions between Indonesia and Malaysia).

Trade has not always led to peaceful outcomes, especially when intra-regional security is not the main objective of the RIA. In fact, the tariff preferences that induce regional trade can create great income transfers between regions and can lead to the concentration of industry in a single location. In the loser countries, separatist movements can arise and may increase the risk of conflict. For example, trade related issues played an important role in the split of Ireland from Great Britain, in the formation of Bangladesh, the break down of the East Africa Common Market and in the leaving of Honduras from the Central American Common Market. To avoid this problem, it is important to have a consensual negotiating style and a good agreement design, in which the winners compensate loser countries or there is a gradual adjustment process for the loser countries. Therefore, regional integration has an ambiguous effect over intra-regional security and the net effect will depend on the economic characteristics of the member countries and on the design of the agreement.

Sometimes, extra-regional security is also the objective under a RIA, especially when member countries have to face common external threats or when one member is able to protect all the other ones. Unfortunately, there is not enough evidence to evaluate the effects of RIAs over extra-regional security. Increasing bargaining power is yet another strong political objective behind some RIAs. Countries can join to have a better bargaining position in trade negotiations. This is especially true for small countries, which may become a significant bloc with a strong voice in negotiations.

Bigger countries also have the incentives to form blocs so that in negotiations, they will increase their bargaining power relative to another big country. This was true in the case of the European Economic Community, whereby one of the original intentions of its formations was to have a better stance in negotiating with the U.S.

Regional integration can also help domestically, as a government tries to implement its political agenda. In particular, RIAs can help to lock in structural reforms. Adjusting to these reforms involves investment, but investments will not be made until investors are confident that the reforms will persist. Indeed, if these investments are not made it is very likely that the government will have to reverse the reforms. To address this problem, governments need institutions and mechanisms that allow them to credibly lock in reforms. Regional integration serves to accomplish this objective because in them, trade preferences are reciprocal and by this, they are a good set of self-enforcing rules. Examples can be seen in the case of Cuba and the negotiations of the FTAA, where this country was left out of the negotiations by a democracy clause, and in MERCOSUR. Another example of the lock in objective is NAFTA, where Mexican and American authorities agreed that if Mexico kept its policies, then it would have access to the American market[7]. In the case of Chile, regional integration was not needed for this purpose, because the commitment and credibility of economic authorities was already high[8]. Therefore regional integration may help, depending on the partner country, but it is not a necessary condition for improving the credibility of reforms.

Finally, another policy-making problem that authorities have to face is to deal with the demands of different lobbies. The latter tends to promote policies that produce transfers from majority to the minority groups engaged in lobbying. Because of this, lobbies are usually led by producer groups, especially producers competing against imports, while the export sector may still be relatively small and undeveloped. This argument supports freeing trade by negotiating RIAs instead of unilateral liberalization, because the first implies limited competition to import substitution producers and better access to the partner's markets for local export sectors (because the agreement implies reciprocity). Thus, on the one hand, there will be less opposition to the agreement, and on the other hand, more support by organized groups.

Thus, political arguments are usually behind RIAs even when economic consequences of the RIA are not the best ones for a country. This doesn't mean that economics is irrelevant to the decision, indeed there are important economic arguments behind RIAs.

ECONOMIC REASONS BEHIND RIAS

RIAs have multiple economic consequences for member countries. They will experience significant changes in resource allocation, which will lead to income transfers between winners and losers, within and between these countries. These effects can be divided into two types, following the methodology of the World Bank. First are effects that arise as separate national markets become more integrated in a single unified market, in particular, more competition and scale effects. Second, the effects that arise as the RIA change the patterns of trade and the location of production.

[7] After the peso crisis in Mexico, authorities raised their tariff for non NAFTA imports without complains by the WTO, because the restrictions imposed were not binding, at least in the Mexican case, so the agreement only enforced Mexico to keep its trade policies inside NAFTA.
[8] It's worth to mention that political conditions were an important factor to lock in reforms.

Size does matter

Many countries are too small to take advantage of the economies of scale required by some activities, subject to increasing returns to scale, to be worthwhile. There are after all a few specialized inputs needed for production or the markets are too small to generate the sales necessaries to cover costs. On the other hand, bigger markets expose firms from different countries to more intense competition, leading to three types of gains. First, firms are induced to reduce prices to competitive levels benefiting consumers, assuming international prices are lower than local ones.

Second, market enlargement allows firms to exploit economies of scale without the trade off between scale economies and competition.. That is, market enlargement allows for both larger firms and increased competition.

Third, intense competition allows firms to reduce internal inefficiencies and raise productivity levels. It is worth mentioning that all these gains can be achieved by non-preferential trade liberalization, as has been confirmed by various studies (e.g. World Bank, 2000). Therefore this argument supports more openness to trade and not RIAs in particular. In this case, the most extensively studied RIA is the European Union (EU), where there have been research efforts to quantify the static and dynamic gains of regional integration. In his 1989 study, Baldwin estimated that the formation of the EU could lead to a static gain of around 5 per cent of GDP, and that scale economies and better resource allocation would lead to permanent gains in higher EU growth rates of between 0.2 and 0.9 per cent. These estimations are very speculative and they cannot be taken as conclusive, but economic theory supports the existence of these dynamic gains.

All the effects discussed above could be amplified in the case of developing countries, where potential gains of regional integration are estimated to be larger than the ones for industrialized countries, specifically if the agreement is a North-South one. It is important to remark that all these potential gains are not automatic and they require careful policy design. Many of the gains can be also achieved through unilateral trade liberalization, although countries will face other difficulties (e.g. political economy problems).

Another point, related to the market size that deserves special attention, is the effects of RIAs on capital flows, in particular foreign direct investment (FDI). According to Blomström and Kokko (1997), "...the most serious problem in the study of the relation between regional integration and foreign direct investment is the multidimensional character of the issue. For instance, it is reasonable to expect that regional integration will have different impacts on investors from the participating economies and outside investors. The impact may vary depending on the character of existing foreign investment: horizontal and vertical investment, or import substituting and export oriented investment, are not likely to be affected in the same manner by the elimination of trade and investment barriers. The major home countries, the countries where Multinational Corporations (MNCs) have their home bases, may experience different effects than the countries hosting foreign MNCs. Integration between developed countries (North-North integration) may differ from integration between developing countries (South-South integration) or agreements between countries at different levels of development (North-South integration), depending on how competitive and complementary economies are".

They found that regional integration could have static and dynamic effects over FDI flows. As for the first type of effect, RIAs are likely to make the integrating region more attractive to outside investors and, by this positive effect, outweigh the negative effect over FDI of trade barriers avoidance. This is due to a large regional market that will be more attractive than separate individual markets, especially in cases where increased competition and more efficiency is achieved. It is impossible to extend this implication for individual countries, because there is no reason to expect that the increase in FDI will be evenly distributed across the region. However increased competition is likely to lead to increased production capacity, and hence FDI allocation that better reflect patterns of regional comparative advantages.

As for the second type effect or dynamic effects are closely related to the growth effects of RIAs. In many instances, some of the improvements needed to increase efficiency, associated with increased competition and exploitation of scale economies, are driven by FDI which in fact become the catalysts for these dynamic effects (Blomström and Kokko, 1997). Also, it is probable that FDI will stimulate technology transfers and diffusion, both directly and through spillovers to local firms.

Changes in trade patterns and the location of production.

Regional integration changes relative prices in member countries. Imports from partner countries become cheaper due to the elimination of tariffs, hence demand patterns will change and with this there will be changes in trade flows. Traditional analysis in this subject was first put forward by Viner (1950) in which the effects of preferential trade liberalization[9] are conceptualized.

Free trade (the purist meaning) allows consumers and firms to purchase from the cheapest source of supply, assuring that production is located according comparative advantage. Trade barriers discriminated against external producers; inducing import substitution producers to expand and as a consequence, reducing the role of the export oriented sector. One may think that under this circumstance, regional integration, while reducing some trade barriers, may generate gains from trade and enhance welfare, but this is not necessary true. If the partner country's production replaced higher cost domestic production, then there will be gains, but in contrast, if it replaced lower cost imports from non-member countries, it will produce efficiency losses. These two effects are known as trade creation and trade diversion respectively. Hence, to evaluate the welfare effects of a RIA, we need to estimate if trade creation will be higher than trade diversion.

[9] In his various studies about this topic, Bhagwati makes a huge difference between free trade and preferential trade agreements.

First the focus will be on trade diversion because of its implications regarding the decision of whether or not to support a RIA. Trade diversion can only occur if the country has a tariff on imports from the rest of the world. The higher the tariff, the higher the cost of trade diversion will be. A clear policy implication is that countries should lower their external tariffs as much as possible, whether they are members of a RIA or not. In particular, RIA member countries will incur small losses due to trade diversion if they have initially have a low tariff on imports from the rest of the world. Another determinant of trade diversion is the cost structure of the partner country. If it is out of line with costs and prices from the rest of the world, trade diversion will be higher. This is the case when the partner country has a high external tariff. Finally, products that are less than perfect substitutes (due to transport costs for example) are less subject to trade diversion. This is an argument in favor of the natural trading bloc hypothesis, which says that forming RIAs with neighbor countries will reduce the effects of trade diversion. The evidence over this point is mixed (Wonnacott and Lutz, 1989; Summers, 1991; Bhagwati and Panagariya, 1996) and one has to also consider that many products traded are commodities or generic products.

Therefore, the lower the external tariffs of the member countries and the more similar they are, the less the potential for trade diversion. Some examples of trade diversion can be seen in the case of the EU's Common Agricultural Policy that diverts consumers' purchases towards EU farmers. A study from Messerlin (1998) quoted by the World Bank (2000) estimates the cost of this protection at 12 percent of total EU farm income. The same study of the World Bank mentioned an example from NAFTA concerning clothes. After the "Tequila" crisis, Mexico increased tariffs on non-NAFTA imports of clothing from 20 percent to 35 percent at the same time it was reducing tariffs on NAFTA imports. As a result, Mexican imports of clothing from the rest of the world fell by 66 percent, while those from the United Sates increased by 47 percent. In general, some calculations made by Panagariya (Bhagwati, 2000) suggest that Mexico's annual loss from trade diversion could be as high as $3 billion due to NAFTA.

The potential for trade diversion is also related to capital goods or other goods used as inputs in production, could reduce the transfer of technology to the country. In this sense, a RIA with an industrialized country would eliminate or, at least, minimize this negative outcome of trade diversion.

Up to now the focus has been on the effects of a RIA over imports, but preferential trade also affects exports and government revenue. One of the arguments in favor of RIAs is that firms benefit from preferential access to partner markets, but this comes at the expense of consumers and government revenues. RIAs are an inefficient way to transfer tariff revenues. As for the effects of RIAs over government revenues, it was found that many developing country governments rely heavily on tariff revenues as a source of domestic revenue. In cases when governments are constrained with respect to alternative revenue sources, this could be damaging, even though this is a second best option, due to the social and political costs of such an outcome. Therefore, it is important to have alternative revenue source in place before reducing tariffs, either under a unilateral liberalization or in a RIA.

The evidence of the effect on trade flows due to RIA is usually based on the estimation of gravity models, where trade between a pair of countries is estimated as a function of factors like the size of the trading countries, the distance between them (as a proxy of transport costs, cultural similarities, etc.), GDP, population and physical factors. Researchers usually add dummy variables to capture if countries belong to a particular RIA or not. A fall in the value of the dummy for trade between a member and a non-member indicates trade diversion. Studies using this methodology (Bayoumi and Eichengreen, 1997 and Soloaga and Winters, 1999) show weak evidence that external trade is smaller because of a RIA, but in general the evidence is not conclusive.

Another important feature of regional integration is that changes in prices will lead to the reallocation of economic activity, modifying industry location across countries, labor demand and wages, and the convergence of member economies. Industries would reallocate themselves based on the comparative advantage of member countries, as well as by considering the investment environment including legislation, regulation, human capital and so on.. Evidence about convergence (World Bank 2000) supports the idea that North-South agreements increase convergence. Whereas for South-South agreements t, preferential trade may distort trade from the North, switching it towards the partner country from the South. In the latter case, for the same reason, one of the partner Southern countries may lose, thus increasing divergence.

Other forces that play an important role here are agglomeration (Silicon Valley) and technological transfers. The first one can be as important as comparative advantage in determining the reallocation of economic activity. The latter is an important determinant of the growth rate of total factor productivity and is closely related to the country's openness. In particular, technological transfer is influenced by how much trade (especially imports) and FDIs (especially inflows) it has with those countries that have the largest stock of knowledge, since trade is a major source of spillover. The obvious policy conclusion here, is that developing countries will gain more from liberalizing trade with industrialized countries rather than with other developing countries when considering a RIA.

POLICY CHOICES AND THE WORLD TRADING SYSTEM

When analyzing the possibility of becoming members of a RIA, countries must make a number of policy decisions. Among them, countries should decide on the most appropriate partners, number of RIAs to participate in, the margin of preference between members and non-members, and how deep and wide integration must be.

On membership, the previous sub sections indicate that a RIA between developing countries will probably not enhance welfare or growth[10]. Therefore, developing countries should seek to become partners with industrialized countries, especially those who have low tariffs and can lead to increased efficiency, competition and large spillovers that may cause permanent growth effects. If the developing country has low tariffs, then trade diversion will probably be small enough to outweigh by trade creation.

As to the decision of whether to become members of more than one RIA, a number of considerations are needed. On the one hand, multiple RIA membership can be equivalent at the maximum to multilateral liberalization (under certain conditions), at least for the country that is the hub of regionalism. Although this is an extreme assumption, the more RIAs a country belongs to, the more similar is its situation will be to complete free trade under multilaeral commitments. Related to this point, if a particular country has RIAs with a number of countries that maintain barriers between each other, this hub country becomes the preferred location for investment. However, net benefits may be positive only under certain conditions. Membership in multiple RIAs increases complexity, in what has been called the "Spaghetti Bowl" phenomenon (Bhagwati 2000) which increases the transactions cost for the private sector. An example of this is the existence of rules of origin, which usually takes the form of some content rule. The product is considered to come from the partner country if its local content exceeds an arbitrarily specified share in gross value. The "spaghetti bowl" phenomenon may also have negative implications at the policy making level. Negotiating RIAs may involve large outlay of human resources, and small countries, which face constraints in administrative and financial resources, which will undoubtedly have limited capacity to negotiate and implement trade agreements (Kotschwar 1999). This problem is larger when negotiating more than one RIA.

Another policy choice a country must face is the margin of preference between members and non-members, and this implies a decision on the tariff levels as well as whether to participate in a free trade area (FTA) or in a custom union (CU). The latter certainly has some benefits, as it eliminates internal borders. However, it also involves costs, such as the loss of national autonomy by giving up its trade policy and the need to harmonize non-tariff barriers and political institutions to deal with this scheme. As the revenues generated by common external tariffs have to be distributed among members, greater coordination between members is required. Further discussion on this issue is beyond the scope of this paper.

One last decision is that countries need to decide when forming a RIA is how broad and deep the integration should be. The policy areas that need to be considered range from trade policy in goods, to labor and environmental policies. It can also include free

[10] Even in the case of MERCOSUR, where trade has increased among members, Brazil and Argentina have suffered from stability problems and lack of strength to proceed with reforms in each country. Argentina was first hit by the devaluation of the real and the lost of competitiveness that this implied (due to the currency board scheme present in Argentina). This shock along an important fiscal deficit generates a financial crisis in Argentina during the first five months of 2001, which in turn has worsen macroeconomic stability in Brazil.

movement of factors, especially, liberalizing service trade and capital flows and harmonizing monetary and fiscal policies. Liberalizing capital flows may let the country to achieve all the benefits discussed above, but to really take advantage of increased capital flows, the country needs to have macroeconomic stability, a sound financial system, good regulation and supervision. If these characteristics do not exist, volatility of capital flows will be harmful and can lead to a financial crisis as has recently been evidenced by the Asian financial crisis.

Free labor mobility on the other hand, may facilitate better resource allocation leading to an increase in competition and efficiency as discussed before. Lastly, the effects of harmonization of policies like fiscal, monetary (optimal monetary areas), labor and environmental standards, requires further research, and is very much dependent on each countries' characteristics.[11] The first two are beyond the scope of this study because they will not be included in the FTA under discussion. About the last two, developing countries should be very careful when discussing labor and environmental policies, especially when negotiating with industrialized countries that have higher wages and environmental standards. Indeed, many times these two items are used as protectionist measures rather than to level the playing field and they intend to artificially raise costs in competing industries in the partner country. Therefore, if the final goal is to level the playing field for fair competition between partners, this should be done in a relative way, considering structural differences and different levels of development between countries.

One final point is the effect of increased regionalism over multilateral and unilateral liberalization. Besides the political and economic causes and consequences of RIAs, many countries belong to blocs because they're worried about the costs of non-membership rather than the benefits of membership, recognizing that the first countries to become members of a RIA will have advantage over future candidates. Others took the road of RIAs after the Seattle round for multilateral liberalization failure (if the highway is not working let's take the dirt road!). In most of these cases, countries are not seeking for closed regionalism; in fact, many of them are looking for freeing trade through RIAs. Of course this will depend on the policy objectives of each country and of each RIA. Some economists and policymakers consider both partial unilateral liberalization and complete bilateral liberalization as second best options. In this case, complete bilateral liberalization may be the best option, rather than partial unilateral liberalization. However evidence of this outcome are still inconclusive (Lawrence, 1999).

With the above as background, we will now begin to discuss the FTA between Chile and the U.S.

[11] The seminal work about optimal monetary areas belongs to Mundell (1961).

FTA between Chile and the U.S

A country with a small internal market needs to actively participate in international trade to benefit from scale economies and specialization in order to achieve a steady growth rate. This is the case of Chile, which since 1974 has implemented a set of structural reforms,- trade liberalization through unilateral liberalization among them,- which permitted the country to achieve substantial growth, control of inflation and poverty alleviation.

Since 1985, Chile has been an active participant in multilateral trade liberalization, first within GATT and next in the WTO. During the last decade, the country negotiated a number of trade agreements with Bolivia, Canada, Colombia, Ecuador, EU, MERCOSUR, Mexico, Peru and Venezuela[12], and currently is negotiating with Korea, Central America, and Panama. Malaysia and the U.S.. Furthermore, it has also signed several investment and double taxation agreements and is actively participating in APEC.

This three complementary strategies, unilateral liberalization, multilateral negotiations and bilateral agreements are the way Chile has chosen to achieve a high level of economic integration with the rest of the world. By this strategy, authorities hope that almost 90 percent of total trade will be free by year 2010.

This is the scenario in which Chile is actually negotiating a FTA with the U.S.. The initiative surged in 1994 when NAFTA members invited Chile to participate in that agreement. However, talks didn’t succeed, so Chile started bilateral negotiations with Canada that ended with a FTA in 1996. Then in 1997, something similar occurred with Mexico, where both countries upgraded an old agreement to a last generation one (including trade services and investment). Finally, in November 2000, President Clinton and President Lagos agreed to start negotiations over a FTA as soon as possible, including talks about trade of goods and services, investment, property rights, competition policies, protectionist measures, controversy solutions, transparency, rules and standards and labor and environmental policies.

The resulting agreement, and its consequences, surely will be similar to NAFTA and to the bilateral agreements between Chile and Mexico and Chile and Canada. Hence, taking those agreements as a starting point, the reasons behind the Chilean-American agreement and its possible costs and benefits are discussed in the following sections.

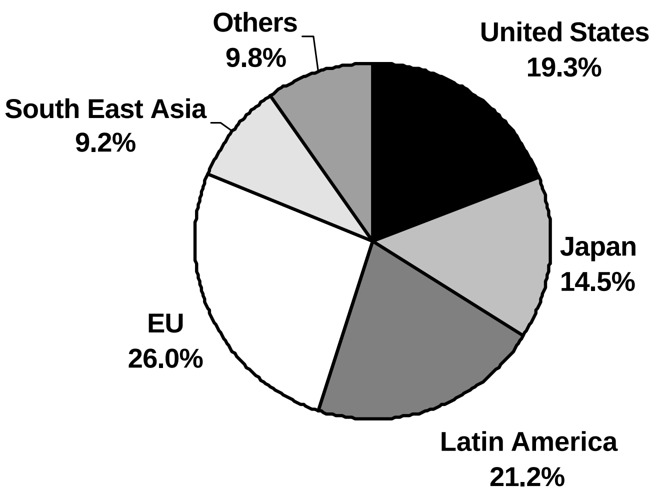
Chilean expectations

Chile is a small open economy, which has based its development strategy in increasing its participation in international economy. Since the mid 1980’s, the export oriented

[12] The agreements with Canada and Mexico are FTA. The others are economic complementation agreements.

sector has been one of the most important engines of economic development through increasing the amount and the diversification of exports.[13] In this context, the U.S. plays a fundamental role. Besides being the world's largest economy, it has been an important trade partner for Chile. During the 1990's exports to the U.S. represents an average 17 per cent of total goods exported and registered an average annual growth of 11.7 per cent p.a. in that period. Meanwhile global exports growth was lower at 8.7 per cent By 1999, the share of exports going to the U.S. had reached 19.3 percent (see figure 1) making it the single largest country destination of Chilean exports, followed by Japan. As for destination of exports by region, 26 percent of exports went to EU and 21.2 per cent going to Latin America. In comparison, only 9.2 per cent of exports was destined to South East Asia.

Figure 1 : Exports Participation by country or region (1999)

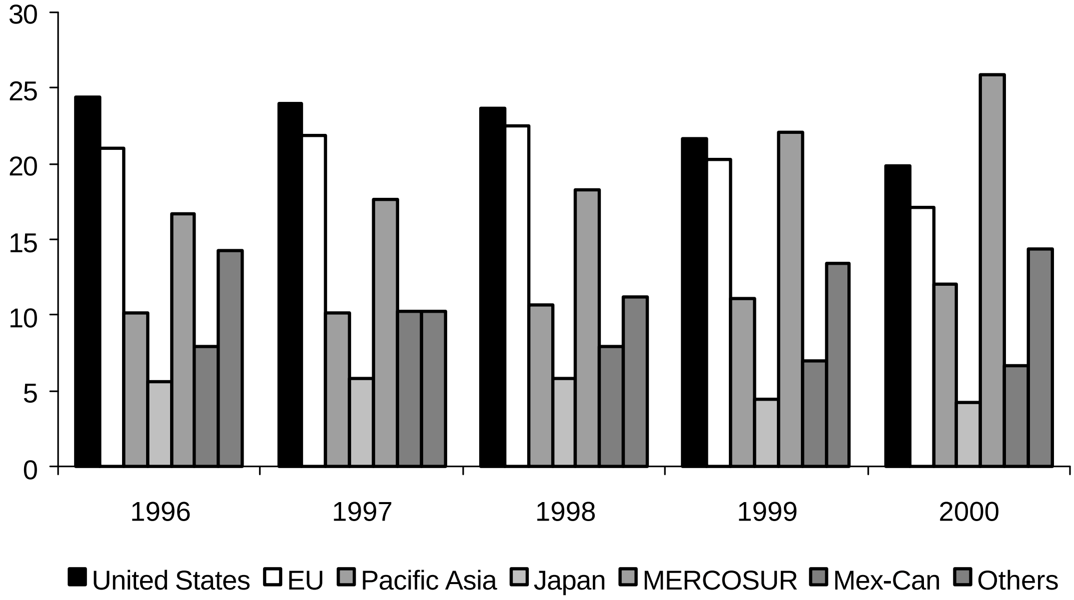


South East Asia includes Indonesia, Malaysia, Philippines, Singapore, South Korea, Thailand and Taiwan.
Source: Central Bank of Chile

Looking at import figures reveals a similar picture. The U.S. accounted for more than 23 per cent of total imports for the 1990's, and with an annual average growth of 11.3 per cent, although during last few years, MERCOSUR has become the first source for Chilean imports. However, the U.S. is the single country where most of Chilean imports come from, as is evident from figure 2. Another point from Figure 2 is that if we compare import participation of NAFTA and MERCOSUR, only during the few last years did the latter's participation become similar to that of NAFTA.

[13] In 1990, copper accounted for 46% of total exports. In 2000, it was 40% of total exports.

Figure 2: Imports participation by country or region
(Percentages)



Pacific Asia includes China, Indonesia, Hong Kong, Malaysia, Philippines, Singapore, Thailand and Taiwan.
Source: Economic relations office of Chile (DIRECON)

Besides being Chile's largest trading partner, a FTA with the U.S. there are other underlying objectives for an FTA with the U.S.. First, it will increase Chilean bargaining power in future negotiations (especially with the EU) and generates enough internal support to outweigh the pressure of lobbies that may oppose the agreement. Furthermore, the American invitation to start negotiations came just at the precise moment, because Chile was negotiating it is accession to MERCOSUR from an associate to a full member due to the political friendship between the Presidents of Argentina, Brazil and Chile. The full incorporation of Chile to the custom union would require Chile to raise its tariff to equalize MERCOSUR common external one. This, without mentioning the instability and the huge problems the two MERCOSUR giants have had during the last 20 years, that could add unnecessary turbulence to the Chilean economy. So, when the FTA negotiation with the U.S. was announced, all trade policymakers attention shifted towards the North, and Chile conditioned its accession to MERCOSUR until the common external tariff of MERCOSUR equalized the Chilean one. After all the objective of Chilean membership to MERCOSUR are more political rather than economic.

Second, is to increase trade flows between both countries. As a proxy, one can analyze what happened with trade flows between Mexico and the U.S. after NAFTA, given that Mexico is a developing country like Chile. Trade between Mexico and the U.S. amounted to $81 billions in 1993 and by 2000, the value of trade reached over $247 billion. U.S. exports inside NAFTA increased by 104 per cent between 1993 and 2000, while trade with the rest of the world increased at a lower rate of 50 per cent in the same time period. Hence, it is likely that after the FTA, trade growth between Chile and the U.S., will be higher than Chile's growth of trade with the rest of the world. Nevertheless, one must be careful about the conclusions in considering the similarities and differences between Chile and Mexico and the fact that the American economy was experiencing a period of unprecedented growth between 1993 and 2000. Furthermore, whilst both Chile and Mexico are developing countries, their production structures are radically different. One strong difference is geographic, with Mexico's proximity to the U.S. and Chile being on the other side of the continent, so transport costs (although they have fallen during the last 20 years) will be higher in the latter case. On the other hand, rules are clearer in Chile than in México where there is still corruption in many sectors, which reduces certainty about future outcomes and increases transaction costs.

The growth of Mexican trade with the U.S. has led some specialists, such as Bhagwati and Panagariya, to believe that there was large trade diversion. However, Anne Krueger has recently analyzed, using a gravity model, that there is preliminary evidence[14] that trade creation has been stronger than trade diversion inside NAFTA (quoted by Coughlin and Wall, 2000). Although NAFTA may have caused trade diversion, the consequences of the FTA between Chile and the U.S. is likely to be slightly different. Due to the characteristics of the two countries, trade diversion appears not to be a major problem. On the one hand, Chile's non-preferential tariff on imports from the rest of the world is low enough to think that losses of welfare involved in the preferential agreement will be of little significance. By one calculation it has been estimated that Mexican losses due to trade diversion in the clothing sector was as high as $3 billion. But the tariff rate on imports from the rest of the world that Mexico had, especially after the "Tequila" crisis was much higher than the Chilean one, so the losses that Chile may suffer caused by trade diversion will be smaller. , U.S. tariff rates are also low, so its cost structure is not radically out of line with world costs structure, minimizing the effects of trade diversion. This is reinforced by the fact that given its size, the American economy does affect world prices, and its high productivity and flexible markets leads to efficient producers, contributing to a cost structure which is more in line with costs and prices from the rest of the world. Therefore, trade diversion generates should be of little concern when talking about the FTA between Chile and the U.S..

Third, the agreement will facilitate the access to the American market for Chilean exports. This is important, not only because of the size of that market or because that country is the most important destination of Chilean exports but to overcome

[14] Kruegger recognizes that it's very difficult to separate economic behavior into pre-NAFTA and post-NAFTA.

protectionist measures to weaken external competition. For instance, some sanitary measures and anti dumping measures have been increasingly used during the last years. A number of Chilean products, such as salmons, grapes and recently, wines, have been subject to anti dumping measures. These kinds of protectionist measures have cost Chile millions of dollars and involved a large amount of resources to counter and respond. For Chile, a FTA agreement that sets clear rules, standards and dispute resolution mechanisms, can be extremely beneficial. Whilst the U.S. will not necessarily change its anti dumping policies due to the FTA, as evidenced from the experience of NAFTA, at least there is a set of clear rules which will reduce uncertainty and discretionary application of such policies, as well as better dispute resolution mechanism as the experience of NAFTA has shown.

So far only static consequences of the FTA have been discussed. In fact the most important consequences for Chile are the dynamic ones,. First, the FTA with the U.S. may increase Chile's access to foreign investors by reducing uncertainty about the effects of Argentina and Brazil's evolution, [15] and by the possibility of using Chile as the entry gate firstly to Latin American markets, and to the Free Trade Area of the Americas in the future.

Second, partnership with a country which has been the source of the of the greatest innovations during last few years of the information and communications technology revolution (ICT) increases the possibilities of enjoying spillovers from FDI and trade.[16] This possibility arises at a time that Chile is seeking to increase growth rates to over 7 per cent a year. Many experts have concluded that what the country needs to achieve that goal, is a second acceleration of productivity increases much like the huge increase in productivity that arose from the structural reforms of the 1980's. Of course besides pursuing the FTA, Chile will have to develop more flexible factor markets (i.e. labor market) and increase human capital investment to adopt ICT and avoid the digital divide.

Closely related to the last point, is the possibility of increasing competition and exploiting scale economies thanks to the FTA. Here, the first round gains of the agreement would be small due to the distance between both countries and the relatively competitive Chilean market. Chile's markets are by and large competitive, except for the agriculture sector, where several restrictions such as safeguards, price bands for wheat, sugar and so on, remain.. Also, it is unlikely that a clustering phenomenon will arise in the Chile-U.S. FTA, where industries agglomerate in the country that has comparative advantage in a particular sector. In the second round effects, where the FTA is seen as a first step towards the Free Trade Area of the Americas (FTAA), the gains can be larger and scale economies, competition and agglomeration would be more important factors.

[15] Chilean sovereign risk is one of the lowest among emerging countries, but the country may be subject to financial squeezing by foreign creditors due to contagion from its neighbors. The FTA may help here to differentiate Chile from the rest of South America, at least during high turbulence periods.
[16] For more details on IT and its effects on the American economy see The Economic Report to the President, 2000.

The conclusion reached here is merely a best guess about the FTA consequences, so that some discussion of empirical evidence is needed. Although, the empirical evidence on the effects for Chile of the FTA with the U.S. is limited and quite outdated, it basically supports the above conceptual discussion. First, a study by Coeymans and Larrain (1996) attempted to estimate the short and long run effects of a bilateral agreement with the United States, considering only trade issues. The authors focused their attention at the sectoral and the aggregate level. They found that the agreement increased trade with the U.S. By sectors, they found that sectors that face the higher initial barriers and are more competitive, would be the most favored ones by the agreement. As a result GDP would increase by 0.26 per cent in the short run and over 10 per cent in the long run (this higher growth arises only while the economy converges to its new steady state equilibrium).

The second study, by Harrison et al. (1997) evaluates three trade policy options for Chile. The three options considered are a FTA with NAFTA, becoming a member of MERCOSUR or unilateral or multilateral liberalization. They found that the last option reports small gains since Chile already has uniform tariffs (11 per cent at the time of the study). Meanwhile trade diversion from an agreement with MERCOSUR dominated trade creation, so reducing welfare. By contrast, an agreement with NAFTA offers enough access to that market for trade creation to dominate trade diversion, thus improving welfare by 1.46 per cent (one time gain) if the external tariff is 6 per cent. None of these studies considered the dynamic effects of the agreement, so there is no evidence that can confirm or refute our hypothesis that these dynamic effects would be the most important ones of a FTA with the U.S.

Therefore, the FTA with the U.S. may allow Chile to obtain all the benefits discussed in the above section with respect to North-South RIAs. But, it is important to remember that RIAs are not a sufficient condition to improve one country's welfare. It is true that it may facilitate liberalization that lead to net welfare gains, but other measures must be taken by the authorities to achieve all the potential gains from the FTA and minimize the losses. In the case of Chile, its macroeconomic fundamentals are sound, but there remains microeconomic distortions that need to be addressed. Thus Chile will need to make its factor markets more flexible, adopt a modern legislation and regulation and continue with the privatization process. This latter point will allow the government to use its scarce resources in areas where it has comparative advantage, such as the provision of public goods and the improvement of education and health standards.

The most important risk of the FTA is with respect to microeconomic issues. If the negotiations end up imposing labor and environmental standards of the U.S. a country that has a $25,000 per capita income to Chile which has a per capita income of slightly over $5,000, the costs of the agreement will raise astronomically. Chilean negotiators and authorities therefore, need to remain firm in facing pressures from many groups to impose restrictions to trade. In particular, trade unions and environmentalist groups (in Chile and the U.S.) will put pressure, especially in the U.S. Congress, to incorporate non tariff barriers in the name of protecting labor and environmental standards.

Finally, Chilean policy makers must be very careful in recognizing their negotiating capacity to deter human capital becoming a binding restriction when negotiating any RIA, specially this one. They also should try to minimize any unnecessary complexities to the agreement, to avoid Bhagwati's spaghetti bowl phenomenon.

WHAT ABOUT THE U.S?

Many reasons can be found to explain Chile's interest in a FTA with the U.S. However, trying to explain why a large country like the U.S wants a FTA with a small distant country is less obvious One can speculate that the motivation of the U.S. is purely political. Actually, for the U.S., the most important RIA would be with the EU considering the size of the population and intra regional trade flows, not NAFTA. The possibility of an Asian RIA is latent. It would appear that the U.S is not in a good negotiating position with other RIAs compared to its position in negotiations of the FTAA. Once this RIA comes to reality, it will be a large regional agreement, and will increase the bargaining power of the U.S. in facing the EU and a potential Asian RIA. However, achieving the FTAA is no easy task. It is necessary to deal with countries that have very different levels of income, values and population. Worst, it means becoming member of a RIA with some of the most economically unstable countries of the world, almost all of them developing ones. In addition, the majority of these countries don't have the institutions, the capacity and the political willingness to accomplish the requirements needed to become members of a positive RIA. As an example, many Latin American countries' governments are highly dependent of tariff revenues, so membership in a RIA of this magnitude without finding alternative sources for revenues may end in a crisis. Here is where the FTA with Chile becomes important. Chile is an example of progress in undertaking structural reform for the rest of Latin America, so the message is that if you do things right, then you will be able to become a partner of the U.S in particular and of the FTAA in general. Therefore, for the U.S. the FTA with Chile should be seen as a first step towards the FTAA.

CONCLUSIONS AND PERSPECTIVES

The liberalization strategy followed by Chilean authorities since 1990 has been on three fronts, that is RIAs, unilateral and multilateral liberalization, with the objective of continuing Chile's export oriented development strategy.

The FTA agreement with the U.S. plays a fundamental role in this strategy. Behind this agreement, there are political and economic reasons. For Chile, economics is the main reason, because the gains it can achieve from an agreement of this kind (and its future developments, such as, the FTAA) is likely to largely dominate the costs.

Almost every trade policy specialist agrees that comprehensive unilateral or multilateral liberalization is the first best policy option but, in the case of Chile, where uniform tariff is already low and multilateral negotiations are stagnant, negotiating RIAs is an option that cannot be rejected ex ante. Economic theory informs us that static gains are likely to be achieved in the case of Chile, but the more important gains are the dynamic ones. However, to maximize a net positive outcome, some conditions must be met:

- Unilateral and multilateral liberalization must go on;
- Minimizing discretionary application of non tariff barriers and the uncertainty that arises;
- Labor, environmental and other legislation and regulations must be set in a way that allows free and fair trade, and not be misused as protectionist measures;
- Several microeconomic reforms are needed to maximize the gains from the FTA;
- Other RIAs could be considered, in light of Chilean negotiating capacity and trying to minimize the complexity of agreements.

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