What kind of Trade Integration helps Latin America the most?

BY JOSEFINA MONTEAGUDO AND MASAKAZU WATANUKI

What types of trade agreement would achieve the best growth results for countries in Latin America and the Caribbean? Study of a simulation model shows that North-South arrangements tend to be better for export stimulus and trade growth in the developing countries of the region. However, South-South agreements help the more advanced developing countries increase their specialization in value-added goods. Constructing and analysing the model are Josefina Monteagudo, an economist, and Masakazu Watanuki, a trade consultant, both with the Inter-American Development Bank in Washington D.C.

OVER THE LAST DECADE and a half, trade integration has proliferated across the world, as renewed regionalism has gained momentum. In Latin America and the Caribbean, countries have reactivated their regional agreements and created new subregional initiatives in an effort to increase their competitiveness in a globalized economy. In the 1990s, they launched more than 20 free trade agreements. Included are South-South agreements such as Mercosur (Argentina and Brazil) as well as North-South agreements such as the North American Free Trade Agreement (NAFTA). Recently, additional free trade arrangements were successfully concluded between Chile and the United States, and Mexico and

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the European Union. These North-South agreements also reactivated Latin America's old South-South regional integration initiatives, as countries look for ways to deepen their agreements into topics beyond free trade of goods and services.

The process is increasingly dynamic, and today the Latin America and the Caribbean (LAC) region faces new challenges within the Western Hemisphere as well as with extra-regional partners like the European Union. Negotiations to create a hemisphere-wide free trade area are about to enter their last year. Talks for the creation of a free trade area between Central America and the United States are underway, and negotiations between the United States and Colombia could be announced in the near future. The European Union and Chile recently agreed to establish a broad trade accord, while free trade negotiations continue between the European Union and Mercosur.

Recent discussion has concentrated on the relative advantages of North-South versus South-South agreements. This is a relatively new research area and requires additional analysis. The World Bank (2000) carried out a comprehensive study and concluded that a North-South agreement is, in general, better for a developing country for several reasons. These include: a North-South agreement is much more likely to confer dynamic benefits than a South-South one; South-South is more likely to produce income divergence; South-South is prone to trade diversion; and a developing country will be able to better exploit its comparative advantage in a North-South agreement.

A further step is to add empirical analysis to the discussion by assessing the quantitative impact of various North-South and South-South regional integration arrangements involving LAC countries. This has now been done for four trade agreements currently proposed or under negotiation. One is a South-South agreement — the South American Free Trade Area (SAFTA). Two are North-South agreements — for the formation of free trade areas between the United States and the Andean Community, and between the European Union and Mercosur. The fourth one combines North-South and South-South agreements — the proposed Free Trade Area of the Americas (FTAA).

This analysis uses a computer model that covers 12 regions or countries and 15 sectors, with a focus on trade. It can model an entire economy in simplified form, using real data from 1997 as the base year. It takes into account all the complex interdependent connections and interactions that exist in real economies, but does not consider financial or monetary markets. It then compares the economies' initial situation with outcomes produced by specific policy changes in each trade agreement. The policy changes introduced in the model are those concerning *ad valorem* tariffs, export subsidies, and domestic producer support measures. The model used is known as a Computable General Equilibrium model, with added information on trade-linked externalities, economies of scale in manufacturing industries, and domestic support programmes. (Readers interested in details about the six main features, five assumptions, three extensions, and relative realism of the model for this study may request a note from the authors at their e-mail addresses given at the end of the article.)

TRADE FLOWS AND STRUCTURE OF PROTECTION

The main destination markets for exports from most LAC countries are the United States and the European Union. The Central America and the Caribbean (CAC) region sells almost 50 per cent of its total exports to the United States, 18 per cent to the European Union, and 13 per cent to its intra-regional market. The Andean Community (Bolivia, Colombia, Ecuador, Peru, Venezuela) presents a similar pattern: 44 per cent of total exports go to the United States, 14 per cent to the European Union and 12 per cent to the intra-bloc market. Mercosur (Argentina and Brazil) has greater export reliance on the European Union (23 per cent) than the United States (15 per cent), while the intra-regional market absorbs nearly 20 per cent of the bloc's exports. Canada and Mexico show heavy export dependence on the United States.

The pattern of imports shows similar regional dependence. For each LAC country, the United States and the European Union are the major sources of imports of intermediate inputs and capital goods, and all show a marginal share of LAC countries' imports. Canada and Mexico also show a very high dependence on the United States as an import source. Chile, Argentina and Brazil have the most balanced pattern with relatively similar dependence on the United States, the European Union, and the Southern Cone markets.

An analysis of exports by sector shows an interesting contrast. For all subregional blocs in the region, their intra-regional exports are more oriented toward heavy manufactured goods. This indicates that subregional markets have an important role in enhancing their export of manufactures. On the other hand, primary products or light manufactured goods are emphasized in all LAC countries' exports (except Brazil's) to the United States and the European Union. Brazil's exports across the Western Hemisphere concentrate on heavy manufactures, but on primary and agro-industry exports to the European Union.

To measure the impact of regional integration agreements, we incorporate in the model the three main policy instruments that distort world prices and restrict trade: tariffs, export subsidies and domestic producer support.

Tariff protection. Included as tariff protection are *ad valorem* tariffs, as well as *ad valorem* equivalents of specific and mixed tariffs levied by the European Union, Canada, the United States, and Mexico, and tariff-rate quotas (TRQs) imposed by Canada, the United States, and Mexico.

Most favoured nation tariff protection for each country is estimated in table 1 for the base year 1997. In the Western Hemisphere, agriculture-related products face high protection relative to manufactured goods. Although the United States has relatively low average barriers (3.9 per cent), it maintains fairly high protection on processed foods (16.5 per cent). Mexico has the third highest average most favoured nation (MFN) tariff (12.3 per cent) after the Mercosur countries, but its protection is the most heterogeneous with the highest tariff on meat products (53.6 per cent). CAC and the Andean countries have similar trade protection structures. Argentina and Brazil maintain a similar tariff structure, where, unlike other Western Hemisphere countries, manufactured goods face higher protection than products of agricultural origin. Mercosur is still an incomplete customs union, given that each country's applied MFN tariffs differ considerably in heavy manufactured products, notably in automobiles and parts (10 percentage points difference), and machinery and equipment (4 percentage points difference). Chile has a moderate and uniform protection of 11 per cent across sectors. In the European Union, agriculture is heavily protected under the Common Agricultural Policy. The bloc maintains the highest protection on sensitive products such as grains and meat products (44 per cent each), followed by processed foods (26 per cent).

In addition to most favoured nation tariff protection, we also incorporate in the model 12 regional trade agreements and preferential arrangements in place in the Western Hemisphere. Seven of these are regional trade agreements — NAFTA, the Central America Common Market, the Caribbean Community, the Andean Community, Mercosur, the G-3 (Colombia, Mexico and Venezuela), and the European Union. Three are bilateral agreements — Mercosur-Chile, Canada-Chile and Mexico-Chile. And two of them are US preferential treatments — the Andean Trade Preference Act (ATPA) and the Caribbean Basin Initiative (CBI). The inclusion of these agreements is crucial in evaluating the heterogeneity in market access and in measuring the effects of trade reform across countries and sectors.

Export subsidies. Based on World Trade Organization notifications, the European Union has by far the largest subsidies, spending 15 times more than the entire Western Hemisphere. Processed foods are the largest recipient, receiving 60 per cent of the EU's total export subsidies, followed by meat (26 per cent) and grains (13 per cent). This leads to higher export subsidy rates for these products, measured by export subsidies over exports: 27 per cent on grains, 22 per cent on meat and 6 per cent on processed foods. In the Western Hemisphere, the United States and Mexico subsidy rates are very small; for CAC and the Andean countries, they range from 5 to 8 per cent.

Domestic producer support. As measured by the OECD Producer Support Estimate (PSE) in agriculture, grains are the largest recipient of production sup-

TABLE 1: MOST FAVOURED NATION TARIFF PROTECTION, 1997 (PER CENT)

	Canada	United States	Mexico	CAC[1]	Colombia	Venezuela	RAC[2]	Argentina	Brazil	Chile	European Union
Grains	11.62	2.35	36.73	12.97	12.50	12.32	11.94	8.14	8.66	11.00	44.21
Vegetables, Oilseeds and Soybeans	4.69	7.12	16.18	16.10	13.46	13.42	13.32	10.48	10.48	11.00	12.93
Sugarcane and Other Crops	2.65	1.29	10.88	10.98	9.26	9.65	8.64	8.73	8.73	11.00	6.19
Livestock	13.57	1.65	13.89	12.32	14.58	14.65	13.14	10.16	10.23	11.00	13.29
Mining	0.83	0.32	8.85	4.92	5.23	5.27	5.86	5.41	6.75	11.00	0.11
Meat Products	46.49	4.88	53.55	28.80	20.00	20.00	20.00	14.87	14.87	11.00	43.80
Processed Foods	28.97	16.49	27.14	18.72	18.13	18.19	17.94	16.19	16.39	11.00	26.22
Textiles and Apparel	15.47	9.84	21.36	13.93	18.14	18.14	18.21	20.24	20.05	11.00	7.92
Other Light Manufactures	5.72	4.55	15.23	14.22	13.95	14.36	14.63	16.62	15.98	10.91	2.20
Petroleum and Chemicals	5.25	4.96	9.80	6.50	8.64	9.11	8.75	10.83	11.02	11.00	4.56
Iron and Steel	4.61	3.27	12.75	6.93	10.42	10.91	10.22	16.01	15.36	11.00	2.05
Automobiles and Parts	6.62	3.17	13.87	12.15	13.18	12.83	13.18	16.50	26.35	10.27	4.14
Machinery and Equipment	3.48	2.57	11.49	6.12	9.33	10.01	9.19	14.09	18.16	10.72	2.53
Utilities and Construction	0	0	0	0	0	0	0	0	0	0	0
Trade and Services	0	0	0	0	0	0	0	0	0	0	0
Average	6.44	3.91	12.33	10.59	10.83	11.37	11.46	13.80	15.81	10.77	4.73

Source: FTAA Hemispheric Database, IDB.

[1] CAC is Central America and the Caribbean

[2] RAC is the rest of the Andean Community

Note: Most favoured nation (MFN) tariffs in the model are the simple average of *ad valorem* tariffs plus *ad valorem* equivalents of specific, mixed and tariff-rate quotas (TRQs) in each sector. The European Union MFN estimation does not include TRQs. Sectoral protection rates by country are the simple average of the corresponding tariff lines. For CAC and RAC, protection data is the simple average of the tariff lines among member countries. Tariff rate "average" is weighted by trade flows.

port, accounting for 62 per cent of the PSE in the United States, 73 per cent in Mexico, 55 per cent in the European Union and 30 per cent in Canada. In the Western Hemisphere, meat is the second largest recipient in all countries. Grains also record the highest domestic support rate, measured by PSE over sectoral production. In the European Union, the highest rates are for vegetables, oilseeds and soybean (72 per cent), grains (59 per cent) and meat (25 per cent).

POLICY SIMULATIONS AND RESULTS

We examine four regional trade agreements involving Latin American and Caribbean countries to measure the potential economic impact of the agreements on the countries, and to evaluate LAC's role in the context of North-South and South-South arrangements. While most of the scenarios reflect ongoing negotiations, others are hypothetical integration options. Under each scenario, we consider the complete elimination of three-policy instruments — tariffs, export subsidies, and domestic support — but exclude other barriers and distortions in trade such as non-tariff barriers, sanitary and phytosanitary (SPS) measures, rules of origin and important institutional factors.

Scenario 1 examines the creation of a South American Free Trade Area (SAFTA) encompassing Mercosur, Chile and the Andean Community countries. The decision to form SAFTA was taken in September 2000 by the heads of state of South American countries, but no further steps have been taken since then. The countries would reciprocally eliminate trade barriers (import tariffs, export subsidies, and domestic support), while maintaining their external protection against third partners. This South-South agreement would have high political significance for Mercosur, especially Brazil, as a strategic step to gain negotiating leverage and to create a counterbalance to the United States in the FTAA process.

Scenario 2 simulates a North-South free trade area between the Andean Community and the United States. Andean countries, except for Venezuela, already have limited and conditioned preferential access to the United States through 2006 under the Andean Trade Promotion and Drug Eradication Act (which renewed and modified the Andean Trade Preference Act of 1991 that expired in 2001). The scenario will bilaterally eliminate all barriers between the United States and the five Andean Community countries. Given the increasing possibility of bilateral trade talks between Colombia and the United States — and also between the latter and Peru — this scenario looks unlikely today, but offers economic insights into how the Andean Community would benefit from trade integration with the United States.

Scenario 3, also a North-South arrangement, simulates a free trade area between the European Union and Mercosur, for which, under a recent agreement, negotiations are to conclude by the end of 2004. Beyond the expected economic gains, Mercosur sees the agreement as a key counterbalance to the US trade dominance and hegemony in the FTAA talks. For the European Union, Mercosur has been a traditional stronghold in the Americas, and remains an important partner in restoring lost market share in LAC. The negotiations hinge heavily on agriculture.

Scenario 4 examines the proposed FTAA, whose agreed timetable calls for finalizing negotiations by January 2005 and entry in force by the end of that year. Although critical issues remain unresolved in many areas, the FTAA process has steadily progressed and has already generated significant positive impacts in a variety of areas. In this scenario, the countries eliminate protection to intra-hemispheric trade, while retaining their protection structures with outside partners.

Simulation results indicate that large-scale trade integration strengthens the linkage between productivity gains and trade expansion, and enhances technical change and spillover among industries throughout the entire economy. Guaranteed access to large markets enables firms to exploit economies of scale, achieve a greater degree of specialization, and promote intra-regional trade in manufactures relative to primary sectors. Trade integration with the European Union promotes more agricultural-oriented specialization in Latin America than does integration with the United States.

Aggregate impact and sectoral results

Table 2 presents the aggregate impact by scenario on real GDP, and export and import growth.

In summary:

- For all member economies, SAFTA generates positive moderate gains. Real GDP grows at a low 0.3 per cent in Colombia and 0.4 per cent in Venezuela, and increases by 1.2 per cent in the rest of the Andean Community members. In Chile, GDP grows at 1.1 per cent, and in Argentina and Brazil around 0.5 per cent. The Andean Community increases total exports by 2.0 per cent, and Mercosur by 1.7 per cent.
- For Andean countries, trade integration with the US is a better option in terms of GDP and export growth. Under both scenarios, the rest of the Andean countries countries benefit more than Colombia and Venezuela.
- For Mercosur, trade integration with the European Union is the best option across the scenarios, bringing the highest GDP growth (4.7 per cent) and the highest total export and import growth of 12.8 and 10 per cent, respectively.
- For the other Western Hemisphere countries, FTAA (scenario 4) is the best option, achieving the highest economic gains and export growth. CAC and the Andean Community increase their real GDP by 2.2 and 2.1 per cent, respectively, and Mercosur by 3.1 per cent. Total exports increase in all regional blocs: in CAC by 8.5 per cent, in Mercosur by 7.9 per cent, and in the Andean Community by 5.6 per cent.

Although there are many factors behind these results, two key elements play a dominant role between countries engaged in an agreement: (i) the base trade links, and (ii) the initial level of protection.

TABLE 2: COMPARATIVE IMPACTS OF THE INTEGRATION SCENARIOS
(PERCENTAGE CHANGE IN REAL GDP, GROSS EXPORTS, AND GROSS IMPORTS)

		Scenario 1	2	3	4
	Base ($ billion)	SAFTA (%)	AC-US FTA (%)	Mercosur -EU FTA (%)	FTAA (%)
REAL GDP					
Canada	630.5	0.00	-0.01	0.04	0.57
United States	7,947.4	0.00	0.15	0.03	0.35
Mexico	381.6	0.00	-0.05	0.03	1.02
NAFTA	**8,959.5**	**0.00**	**0.13**	**0.03**	**0.39**
CAC	**93.3**	**-0.01**	**-0.07**	**0.04**	**2.22**
Colombia	93.6	0.28	0.92	0.05	1.32
Venezuela	84.6	0.37	1.40	0.10	2.08
RAC	91.1	1.21	1.78	0.21	2.98
Andean Community	**269.3**	**0.62**	**1.36**	**0.12**	**2.12**
Argentina	336.5	0.61	0.00	4.20	2.49
Brazil	808.2	0.46	-0.01	4.94	3.39
Mercosur	**1,144.7**	**0.50**	**-0.01**	**4.72**	**3.12**
Chile	76.1	1.14	-0.01	0.11	2.84
European Union	**8,001.2**	**0.00**	**0.00**	**0.61**	**-0.01**
GROSS EXPORTS					
Canada	196.6	-0.01	0.03	0.18	1.42
United States	623.2	-0.01	0.26	0.12	1.92
Mexico	110.1	-0.01	-0.10	0.10	2.00
NAFTA	**929.9**	**-0.01**	**0.17**	**0.13**	**1.83**
CAC	**30.3**	**-0.03**	**-0.12**	**0.23**	**8.48**
Colombia	10.5	1.65	3.04	0.16	4.92
Venezuela	22.8	1.03	2.46	0.24	4.42
RAC	13.1	3.85	4.41	0.56	8.33
Andean Community	**46.4**	**1.97**	**3.14**	**0.31**	**5.64**
Argentina	26.2	2.13	0.00	12.60	6.67
Brazil	52.4	1.49	-0.08	12.93	8.50
Mercosur	**78.6**	**1.71**	**-0.05**	**12.82**	**7.89**
Chile	16.7	3.47	0.00	0.33	7.73
European Union	**1,917.2**	**0.00**	**-0.02**	**1.14**	**-0.07**
GROSS IMPORTS					
Canada	190.4	0.00	-0.01	0.15	1.45
United States	856.2	0.00	0.17	0.12	1.13
Mexico	105.4	-0.01	-0.13	0.09	2.08
NAFTA	**1,151.9**	**0.00**	**0.11**	**0.12**	**1.27**
CAC	**53.2**	**-0.02**	**-0.10**	**0.11**	**5.29**
Colombia	13.9	1.32	3.23	0.13	4.87
Venezuela	14.6	1.67	4.40	0.29	7.44
RAC	15.9	3.43	3.98	0.32	7.48
Andean Community	**44.4**	**2.19**	**3.88**	**0.25**	**6.65**
Argentina	30.7	1.61	0.01	10.05	5.75
Brazil	64.5	0.99	-0.04	9.78	7.13
Mercosur	**95.2**	**1.19**	**-0.02**	**9.87**	**6.69**
Chile	18.1	2.83	0.00	0.24	6.74
European Union	**1,908.3**	**0.00**	**-0.01**	**1.16**	**-0.02**

Note: The impact on trade is measured by changes in trade in goods, excluding trade in services.

Figure 1 presents the impact on exports by macro-sector and destination under the four scenarios.

Scenario 1: SAFTA

The creation of SAFTA increases exports by 7 per cent within South America, while inter-regional trade between the Andean Community and Mercosur, and the Andean Community and Chile expands by more than 20 per cent. The impact on export performance is unevenly distributed: Andean Community countries expand total exports by 3.8 per cent and Chile by 3.5 per cent; while exports grow in Venezuela only 1 per cent. An interesting result is the high intra-industry share of manufactures in new trade flows. Heavy manufactured goods account for nearly half of the increased trade, and light manufactures' share is about one third.

Brazil is the largest exporter in value terms to the SAFTA market. It increases exports of heavy manufactures by 7 per cent to the expanded market, accounting for around half of the new heavy manufactured exports. Automobiles are the leading export (in value terms) and also one of the most booming industries (9.1 per cent increase), followed by iron and steel (7.2 per cent increase). Argentine exports to the SAFTA partners are more concentrated in light manufactures such as processed foods, which grow 12 per cent, and agricultural exports. Chile also expands light manufactured exports to South America by 25 per cent. Regarding the Andean countries, the formation of SAFTA increases manufactured exports, as the countries expand their resource-based exports — mining plus petroleum and chemicals, largely from Colombia and Venezuela — amounting to 30 per cent of the new exports to the intraregional market.

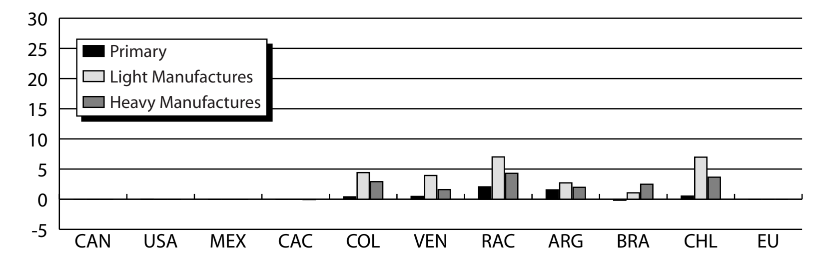
While SAFTA might bring about relatively modest economic gains to its member economies, this trade arrangement represents, as already mentioned, an important strategic option with significant political importance. By consolidating regional integration, South America can significantly raise its international bargaining power in negotiations with the United States (FTAA) and the European Union.

Scenario 2: Free trade agreement between the Andean Community and the United States

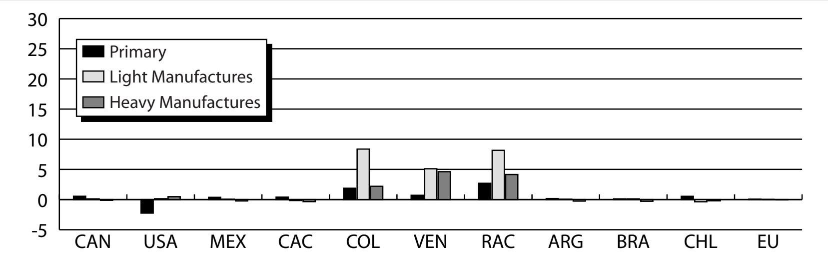
The results of this trade integration agreement reflect two factors: (i) the bloc's trade links, especially export structure, with the United States; and (ii) the existing US preferential arrangement, ATPA. Before liberalization, resource-based products such as mining (oil and gas) as well as petroleum and chemicals dominated the bloc's exports to the United States, accounting for three-quarters of total exports to that market. The United States already offers fairly low barriers on these imports under the ATPA: almost no protection on oil and gas, and modest

FIGURE 1: IMPACT ON TOTAL EXPORTS BY MACRO-SECTOR (PERCENTAGE CHANGE)

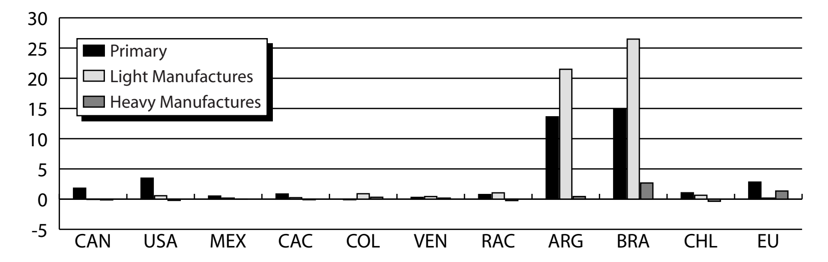
SCENARIO 1: SAFTA



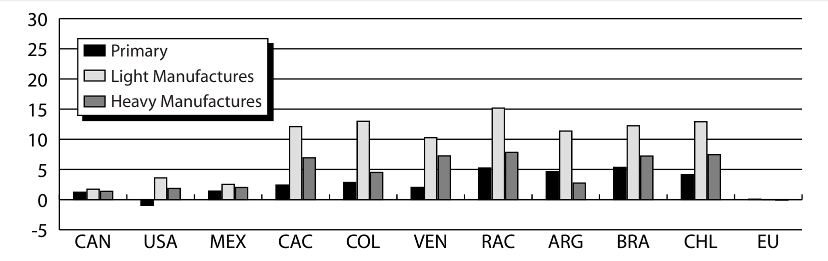
SCENARIO 2: Andean-US FTA



SCENARIO 3: Mercosur-EU FTA



SCENARIO 4: FTAA



protection on petroleum and chemicals (5 per cent on Venezuela and 2.6 per cent on the other Andean members). On the other hand, the export share of light manufactures is only 5 per cent of the group's total exports to the United States.

As a consequence, the impact on export growth is a modest 3.6 per cent. By macro-sector, exports of light manufactures to the northern markets jump by 17 per cent (due to the small base), heavy manufactured exports by 6.6 per cent, and primary exports by 1.4 per cent. In value terms, however, heavy manufactured products, driven by petroleum and chemicals, primarily from Venezuela, account for half of the increased exports to the United States, whereas primary and light manufactured exports account for around a one-quarter share each. Venezuela, the bloc's main exporter, accounts for almost 50 per cent of the increased exports to the United States, and Colombia for 21 per cent. The agreement also activates intra-Andean exports, which grow by 3.5 per cent. In contrast with the composition of exports to the United States, light manufactures account for half of the intra-bloc exports and heavy manufactured goods one third.

The results show signs of trade diversion. Due to the initially high most favoured nation tariff, the Andean countries shift their source of imports away from third countries and in favour of the United States, illustrated by a 14 per cent increase in imports from the United States. Of these new imports from the US, heavy manufactured goods — capital and intermediate goods — represent the majority of products, with machinery and equipment accounting for 40 per cent.

Scenario 3: Mercosur-EU FTA

Trade integration with the European Union is the best option for Mercosur. Economic gains and export growth are the largest for each individual member, as the growth of GDP and exports increases 50 per cent more than the figures from the FTAA initiative (scenario 4).

The bi-regional FTA raises the region's exports to the European Union by 37 per cent. The removal of the EU's high protection in agriculture is a key element leading to Mercosur's expansion of agricultural exports, in which Mercosur has a clear comparative advantage and strong international competitiveness. Agricultural exports constitute 98 per cent of the increased exports to the European Union in Argentina and 93 per cent in Brazil. Meat products and processed foods account for 65 per cent of the increased exports to the EU market.

Due largely to a small base of exports and the EU's high initial protection, the two fast growing sectors are meat products and grains, with growth rates as high as 120 per cent and 420 per cent, respectively. Exports of manufactured goods also increase, but at the relatively moderate pace of 5.4 per cent. In value terms, Brazil's exports of heavy manufactures to the European Union exceed those of Argentina. An important result is that while Brazil expands intra-bloc exports across sectors, Argentina suffers a decline in exports of machinery and equipment to Brazil, as a result of losing the preferential access and high dependency on the Brazilian market.

Mercosur increases imports from the European Union by 30 per cent. Manufactures are the major imports from the European Union (90 per cent), with high concentration on heavy manufactures, mainly capital, intermediate and consumer durable goods. Machinery and equipment account for half of total imports. Unlike the previous scenarios, this scenario does not show trade diversion effects.

Scenario 4: Free Trade Area of the Americas

Compared with SAFTA, FTAA induces 2.9 times larger export growth for the Andean Community, 4.5 times for Mercosur, and 2.2 times for Chile. Compared with the integration with the United States in scenario 2, the Andean Community further increases its exports by 80 per cent. Due to NAFTA, the export growth in North American countries remains modest.

FTAA increases Latin America's exports to the Western Hemisphere market by 11 per cent, generating a strong export growth of light manufactures in all LAC countries except Mexico. Andean countries, especially Venezuela and to some extent Colombia, further expand resource-based exports (petroleum and chemicals, as well as oil and gas). In Mercosur, processed foods are the fastest growing industries and leading export earners, although Brazil substantially boosts heavy manufactured exports to the entire hemisphere market (7.7 per cent growth). Chile's highest increases are in agricultural exports (vegetables and processed foods), followed by resource-based metal products, with the majority destined to the United States. FTAA brings about promising export growth of CAC to the United States, which has long sought NAFTA-parity treatment. The bloc increases textile and apparel exports, which account for 70 per cent of its exports destined to the United States.

FTAA facilitates strong export growth of manufactured goods in LAC, in sharp contrast with the result of Mercosur integration with the European Union. Interestingly, Latin America absorbs nearly 50 per cent of the increased exports to the FTAA market, and heavy manufactures represent a 50 per cent share of the new exports traded within Latin America. As we move down to the south, the share of intra-LAC trade in total trade increases. For the Andean Community, Mercosur and Chile, this share surpasses 60 per cent for heavy manufactures, and rises over 80 per cent in several manufacturing industries. Thus, the presence of LAC countries raises exports of non-resource-based heavy manufactures for the countries in South America. This is particularly the case with Brazil.

As a result of efficiency gains, LAC is

more competitive in the international market with exports, especially in light manufactures, increasing even to third parties outside the agreement. The impact on imports is similar to the one under integration with the United States. LAC increases imports of capital goods (machinery and equipment), intermediates (petroleum and chemicals) and consumer durable goods (automobiles and parts). The European Union, excluded from the agreement, faces trade diversion and its trade with the hemispheric partners declines.

CONCLUSIONS

Regional trade integration is not simply a matter of maximizing potential economic gains or balancing benefits and costs. It involves national economic strategies that have domestic political ramifications. It is concerned with structural transformation, with particular impact on adjustment of the labour market and survival of weak industries. Despite difficult economic and political situations in some LAC countries, the region has adopted an active integration agenda in the Western Hemisphere and with the European Union that will significantly influence the region's future.

The simulation results for four regional initiatives show that SAFTA, a South-South arrangement, generates modest economic gains for member counties, but its effect might be seen more on the strategic, political economy interests of South American countries. The North-South arrangements evaluated generate considerably heterogeneous impact on Latin American countries. Andean trade integration with the United States is greatly affected by the Andean Community's resource-based economic and trade structures; and Mercosur's gains from trade integration with the European Union accrue from the EU's import-sensitive agricultural sectors and Mercosur's competitiveness in that sector. The FTAA (a 'mixed' North-South/South-South agreement) is the best option for most Latin American countries except for Mercosur, generating sizable economic and trade gains.

The analysis by macro-sector shows that light manufactures are the fastest growing sector for the LAC countries in all scenarios. This is in part driven by the fact that light manufactures, led by agriculture-related products (meat and processed foods), face higher protection than other sectors in both the United States and the European Union. This result shows the LAC region's comparative advantage and competitiveness when facing an agreement with developed countries. For the Andean countries, the FTAA reflects a similar pattern of growth across macro-sectors as does the FTA with the United States: specialization in light manufactures followed by heavy manufactures. Mercosur, a middle-income and semi-industrialized bloc, attains dynamic gains from greater integration, improves efficiency gains, and exploits economies of scale in manufacturing industries. Integration with hemispheric partners shows that heavy manufactures are the sectors with the highest share of increased exports for Mercosur, while this is the case in resource-based manufactures for the Andean countries.

As for the FTAA, we find an interesting result in evaluating the LAC region's participation. In this agreement, LAC countries absorb nearly half of the region's increased exports to the FTAA market, and heavy manufactured products account for 50 per cent of the new exports traded in Latin America. For the South American partners, the share of Latin America over the FTAA market in their heavy manufactured exports well exceeds 60 per cent and even rises over 80 per cent in several industries. Thus, the presence of Latin America contributes to increased exports of non-resource-based manufactures for South America. This is an important finding given that specialization in manufactured goods is preferable to primary goods, thus highlighting the importance of the intra-LAC market in the Free Trade Area of the Americas.

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