

FTAA AND LIBERALIZATION: INSTITUTIONAL ISSUES

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ABSTRACT

For any bilateral or multilateral trade agreement to be effective, it is imperative that all participants derive maximum benefit. This paper highlights the institutional issues facing the partners of the Free Trade of the Area of the Americas (FTAA), analyzes some of the current areas of conflict and suggests action to reduce tensions and promote harmony, cooperation and accommodation which is necessary when multiple countries attempt to foster such an agreement.

Introduction

Every nation planning to participate in opening its borders to a trade agreement has by necessity the goal of growth of development through increased trade and commerce void of tariffs and quotas. The nations that are currently party to the proposed Free Trade Area of the Americas agreement (FTAA) are no exception. Each member has unique needs and concerns, but almost all are participating to bring the benefits of free trade down to the level of each member of their community.

Efforts to create this trading bloc began just after the creation of the North American Free Trade Agreement (NAFTA) in 1994 and by most expectations implementation should have materialized on January 1, 2005 the target date set. Not only has this not taken place, questions are being raised if a realistic date can actually be set at all. A recent report in February 2005 is headlined "Is the FTAA Floundering?" and concludes that "the failure to reach an accord by the agreed-upon date could mean there will never be an FTAA." (Meza, 2005) FTAA talks ground to a halt last year. (Colitt, 2005)

This paper is another effort in appraising the challenges of trade liberalization in the context of the FTAA, evaluates the issues and concerns of members who are

primarily developing economies and suggests overtures that are necessary to address these issues of there is to be an agreement that will benefit all participants.

Multilateralism

The Free Trade Area of the Americas is a progressive and modern effort to remove all barriers to trade and investment by 2005 and thereby unite all the thirty-four economies into one single trade area. Trade liberalization is not completely new to the post-war world and has been introduced in numerous forms. GATT brought the concept of the *most favored nation* (MFN) under the umbrella of multilateralism. As a consequence, protectionist measures though altogether not eliminated were withdrawn equally and in stages in respect of other member nations. Another such move was the formation of Customs Unions. These unions are discrete and so directly violate the principles of multilateralism [Harrison 1979]. Trade liberalization within a small region was also another cooperative effort for promotion of mutual trade. Regionalism is not without contradictions but the countries in the Asia Pacific Economic Cooperation (APEC) have resorted to a policy of open regionalism removing thereby any discriminatory practice [Scollay 2001]. Preferential trade arrangements (PTAs) cause a fall in tariff levels and this becomes an incentive for new memberships [Freund 2000] but do result in a diversion of trade [Krishna 1998]. Exploration of proliferation of free trade agreements in the ASEAN area to promote multilateralism is a policy of the World Trade Organization [Sellakumaran 2004].

Multilateralism by conventional wisdom leads to nondiscrimination and reciprocity [Ethier 2004] while bilateralism and preferential trade agreements both may lead to trade diversion [Moser 1995]. The resultant trade growth due to multilateralism promotes output growth and trade liberalization [Greenaway 1990]. For low-income countries, institutional and structural characteristics are more important determinants than multilateral reforms including trade liberalization [Sindzingre 2005]. Even countries practicing open trade policy could reap the benefits of trade creation through multilateralism. Canada has demonstrated this amply well by entering into numerous unilateral and bilateral trade arrangements and eliminations of tariff [Head and Ries 2004].

Background

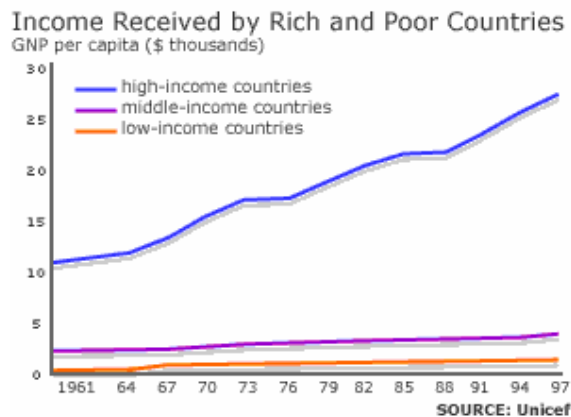
The project was launched some fifteen years ago by the then President of the United States George Herbert Walker Bush as a solution that would integrate all the countries in North, Central and South America and the Caribbean. This would have created the world's largest free market, with a combined gross domestic product of US\$13 trillion and 800 million consumers from Alaska to Argentina. (Petry, 2004)

The limited success of NAFTA, encouraged by the US's drive towards maximizing cross border trade, resulted in the signing of the Central American Free Trade Agreement (CAFTA) in December 2003. Another trade agreement – MERCOSUR - tied together the economies of Argentina, Chile, Brazil, Uruguay and Paraguay. The many lessons that have been learnt from the negotiations process, structuring and implementing of these agreements should have resulted in greater success in

pursuing FTAA goals, but this does not seem to have been the case. The major differences seem to focus on the fact that there is a great disparity among participating nations. Although the EU does include countries with different levels of development, these gaps are nowhere near as wide as those that exist among member of the 34 diverse countries of the Americas. (Meza, 2005)

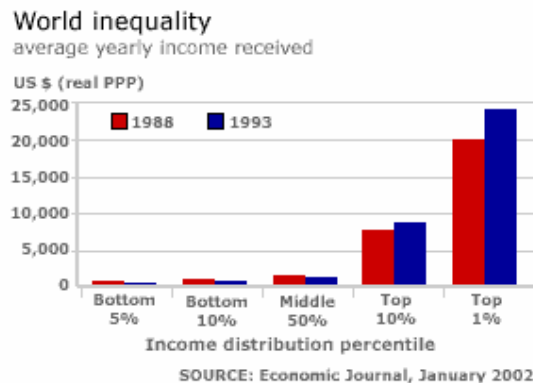
Distribution of Wealth in Developing Countries

World inequality remains a real concern for all countries, developed and developing. There exists a great divide among the poor and rich nations and within the countries as well.



(World Inequality: Global Policy Forum, 2002)

The divide does not seem to be getting any smaller. World inequality between households has increased. The income of the richest 1% (50 million people) is the same as the income of the poorest 60% (2.7 billion people).



(World Inequality: Global Policy Forum, 2002)

The 2002 figures of the number of people living in poverty in Latin America reached 220 million – or 43.4 percent of the total population – and this figure is rising on

year after year. (Meza, 2005) While countries try to achieve greater equality in the distribution of wealth, incomes and opportunities by broadening access to public services such as education, health, water, electricity and land and rural services, free trade runs completely opposite to the policies of poor countries attempts at providing the basic amenities to its population through public entities while FTAA presses countries “to privatize health care, water, and electricity and to charge ‘user fees’ on public services such as education.” (Sierakowski et.al. 2004) The net result of this disparity is the inability for the participants to negotiate on an equal footing.

Concerns of Labor

The question of labor standards has been plaguing all multilateral agreements including the World Trade Organization (WTO). Labor organizations all over the world are concerned about the exploitation of labor, the degradation of the environment, and the undermining of national regulations designed to protect the health and safety of citizens. (AFL-CIO, 1999) Liberalization of trade necessarily means a restructuring of existing labor policies and standards. Labor organizations are continually in support for linkages of trade and labor standards, though governments of developed countries such as the United States have been hesitant and often strongly opposed. Arguments in favor of linking for include:

1. Trade sanctions as an enforcement device. This would raise the enforcement of labor standards and trade can provide a tool for ensuring compliance.
2. Setting efficient labor standards. The fear is that large, capital-abundant countries may set their labor standards at a point where the marginal benefit exceeds marginal cost, thus under-regulating their labor markets.
3. Bargaining inefficiencies. Governments may be motivated to replace inefficient trade policies with inefficient labor policies.
4. Bargaining Complementarities. When countries negotiate on multiple issues, all can gain by linking those negotiations.

Arguments against linkage are:

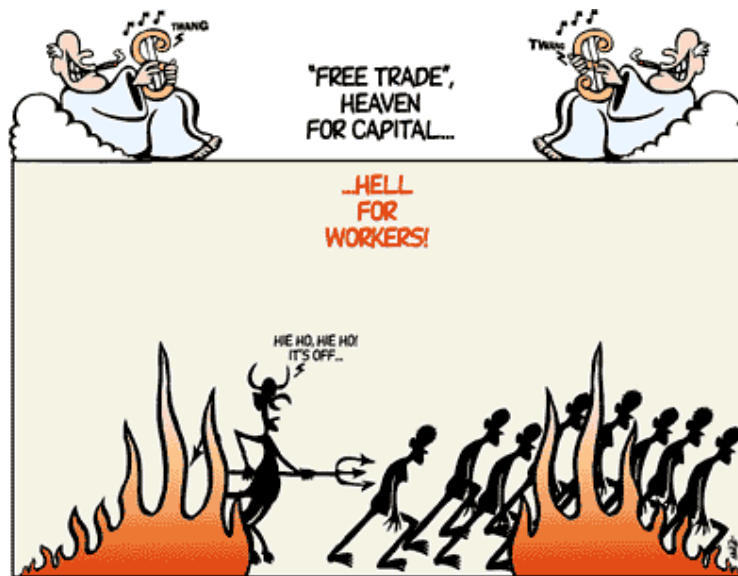
1. Efficacy of labor standards. This is questioned as whether simply imposing better conditions will in fact make all workers better off. If higher standards are imposed, then the cost of hiring labor will rise and fewer workers will be hired.
2. Trade sanctions may be inappropriately applied. There exists a possibility that trade sanctions will be co-opted for protectionist purposes.

An extensive assessment of these issues done by Brown, Deardorff and Stern in 2002 concludes that “trade sanctions are not very attractive for expressing humanitarian concerns” (Brown et.al. 2002).

Much debate is currently taking place with regards the FTAA and worker rights. Workers through their representatives may be feeling left out as there is not a direct representative serving their needs. The exploitation of labor is a major concern as is

the need for proper compensations and benefits. A report on CAFTA “The Real Record on Workers Rights in Central America” released on April 4, 2005 charges that “the labor provisions in CAFTA fall short in at least 20 areas of recognized international labor standards, such as the right to form a union or a ban against child labor.” (AFL-CIO, 2005)

The negative affects of trade liberalization on labor has many supporters both in the developed economies as well as in developing countries. This is becoming a somewhat anti-capitalism fervor, and is resulting in strong protests at meeting venues. Crucial issues raised include the harmful effects of free trade on women and minorities, the fear that investor rights will take tremendous priority over human rights, the existence of sweatshops in Latin America, very low or even no wages, and these continue to be the bone of contention at every level. The following is just an example of vehement opposition to trade liberalization by labor:



Source: UE: Battling the FTAA http://www.ranknfile-ue.org/polact_ftaa_gaff.html

Multilateral Trade and Tariff Issues

The fundamental reason for establishing the FTAA is that trade liberalization will foster economic growth, reduce poverty and speed development. This would necessarily lead to direct benefits to consumers through the competition created by lifting of tariffs and market access. The main concern here is that developed nations, especially in this case the United States, which has comparative advantage in most services such as finance, transportation, engineering, technology, will lead to a tilt in the benefits accrued by some partners.

The one obstacle is the reality that in the face of an overall 34 nation agreement, the US continues to broaden its bilateral and multilateral treaties. One claim is that CAFTA has the potential of paving the way for the FTAA. However, CAFTA has yet to produce the desired results. MERCOSUR is another sticking point in that its participants are not ready to agree to a larger agreement. This has led the FTAA

grouping to take on a two-tier approach led by the US and Brazil, the two largest economies who have different priorities. The US is pushing for broad based tariff elimination while Brazil prefers to address peak tariffs and tariff rate quotas (TRQs) (Hornbeck, 2005) The US favors a comprehensive agreement while Brazil aims to keep the talks focused solely on trade.

Another major issue is the subsidies on agriculture which could be the major stumbling block as negotiators are deadlocked in their positions. The issue is further exacerbated by the fact that US does not intend to compromise on this sector, while most of the developing countries depend on agriculture. The US is pushing for greater market and investment access for its products, a coalition of 21 developing countries is pushing back, demanding an end to agricultural subsidies (Global Fairness, 2005). One of the fears is dumping. The Americas Trade and Development Forum (ATSDF) recommended that FTAA agriculture rules should:

1. Grant all countries the right to develop their own agriculture and food policies, including the right to manage both production and inventories.
2. Grant countries the right to protect themselves from dumping of agricultural commodities at below the cost of production.
3. Prohibit dumping by any country into international markets.
4. Provide farmers with a fair price and consumers with a safe, secure and affordable food supply that is environmentally sustainable.
5. Reduce the anti-competitive market distortions caused by the disproportionate market power of agribusiness cartels. (Institute of Agriculture and Trade Policy, 2003)

However, these recommendations, though noteworthy, have not received due consideration. Up to the time of writing, negotiations have halted; and major differences between the US and Brazil prevail. The contentious area of agriculture remains a major obstacle, especially since both the US and Brazil are major producers and exporters. The parties could agree on different speeds of integration, which will allow them to exclude contentious issues, such as intellectual property rights and agriculture (Ishmael, 2005).

Currency Problems and Exchange Rates

Many such bilateral, multilateral and regional cooperative measures have their deep roots in the less developed countries' inability to pay for the inevitable imports in hard currencies. These currency problems continued to wreck the soft currencies and the respective balance of payments. Countries in the Nonaligned Movement (NAM) are still being haunted by their colonial past and have been skeptical of the various trade treaties and the wave of globalization while its key member state of India is engaged in a process of systematic liberalization. Despite new currencies with uncertain values, varying degrees of convertibility and divergent exchange rate regimes and restrictions, the erstwhile eastern bloc countries have proved that multilateralism allows non-discriminatory trade [Pomfret 2003]. Financial deregulation in the last decade is another move by the emerging economies

to remove the currency problems by series of steps such as economic and financial liberalization, removal of exchange control and restrictions on current account convertibility and introduction of incentives for international investors to provide stimulus for the inefficient domestic sectors.

Dollarization

Countries in the free trade area have often faced huge trade deficits and in some cases this has added to their pre-existing difficulties of servicing their foreign debt. Severe shortages of dollars and unbridled inflationary trends in the domestic environment have compelled countries like Ecuador to dollarize their economy. El Salvador and Panama have also resorted to substitution of their home currencies with US dollars. Besides losing the benefits of seigniorage, the central banks also surrender their autonomy by withdrawing a currency exchange rate mechanism and thereby their tool of intervention. The dollar is not the panacea unless the banking systems in these countries become completely sound, modernized and efficient. Despite the price stability that dollarization may bring to economies in transition, researchers also recommend an optimally managed exchange rate regime to direct the economy at times of fluctuating growth [Hudgins and Yoskowitz 2004].

Payment and Settlement Issues

Since most of the countries in the free trade area may agree to invoice the products in US dollar, currency problems may have been resolved but not problems pertaining to payment and settlement. The methods of settlement and the risks associated with international trade are global issues and so a free trade area is not the solution in itself. Technology involving the flows is still being tested and implemented by the developing countries and efforts to unify the systems are yet to be fully envisioned.

Cross Border Trade Credit

Trade credit is conventional and mostly safe. So, commercial banks will now find a new field for intense competition. The free trade area thus will have to pave way for cross border commercial banks to compete on their levels of efficiency, international interest rates, cost savings to the clients, speedy transfers and also large international presence. The competitiveness in domestic banking sector is prone to increase, yet it might result in dwindling profits and subsequent closure of some institutions. This may lead to a higher impact on credit creation and its multiplier effect. Without an adequate support of insurance and reinsurance, the financial services as a whole sector will be limited in its overall performance.

Marketing Issues

The FTAA through the elimination of barriers will provide the citizens of the countries involved with the latest products incorporating the latest technologies at the lowest possible prices. It will do this in two ways: first by allowing foreign firms to compete on an equal basis with local firms. And as a corollary to the first, it will force local firms to upgrade their core competencies in order to compete. The FTAA will provide businesses who buy from other businesses (B-2-B) with additional

means to find the right product, at the right place at the right time for the right price. FTAA will do this by reducing and then eliminating artificial impediments to trade - tariff and non-tariff barriers. These barriers forced the buying centers in B-2-B organizations to select products not on the basis of what is best for the organization's core competencies, i.e., latest technology, highest quality, best delivery, internationally competitive price but on the basis local price. This meant that the final product produced by the organizations in a protected environment although competitive within the home country may not have been able to compete internationally.

Changes in Traditional Business Models

Prior to the FTAA, the typical business model required little more than that a vendor be located as near as possible to the customer within each protected market in order to give the pricing and service required to develop and maintain Customer Relationship Management. However basic marketing principles are to first review the environment for opportunities and threats before establishing a segmentation strategy that will allow the development of an appropriate marketing mix for each distinct element in each segment. Kotler, Marketing Management, 11ed. Marketing strategies will change significantly after FTAA.

Competitive Environment

The organization will have to expand the (or perhaps begin to) review of competitors around the world, not simply within the company or even the region, before establishing a segmentation strategy. It would no longer make sense for the organization to ignore a major competitor outside the region if this competitor could take away its business. The internet is making it possible and even likely that vendors and customers may be in different countries, regions or even continents.

Market Segmentation

FTAA potentially expands the market at the same time as it provides the likelihood of additional competitors. If the organization is able to compete with international organizations in its own country, it may be able to compete with them in other countries. This will provide additional economies of scale and possibly additional profits. The challenge will be how to do so? How to search for customers in other countries? How to know that a potential customer in another country is a customer? The criteria used in the home country may be quite different. Differences in culture can impact differences in demand (Hofstede, 1997). An example may be seen in Asia. Asia has many companies selling products for Chinese New Year. America does not have this as a major holiday. However, many of the products suitable for Chinese New Year may also be suitable for Christmas. There are many such opportunities in the FTAA area but the challenge will be to look at them through a different cultural perspective.

Product

A major issue for all organizations is to determine exactly what a customer wants to buy. Kotler and Pride concur with many other authors in concluding that a large percentage of new products fail (Kotler, 2003 and Pride & Ferrell, 2006). The reasons for these are myriad but usually due to improper market research, poor planning and insufficient demand for the product. However one of the major criteria for a successful product can be packaging. The color, the size, the verbiage on the package all contribute to a successful product. When selling in another country these concepts become quite complicated. For example when products are imported from Asia to America, products must be translated into English (often with ludicrous results), must have ingredients listed (if the products are edible), and should come in appropriate colors. Language and color of packing are heavily culturally laden. For example, what colors are preferred? White is a symbol of purity in America, hence it is used for wedding gowns. In Asia, yellow is a regal color since it was the color Emperors wore. In the west, the regal color was purple. Lastly should the organization change its product to 'fit' a market in an adjacent country? Some of the world brand leaders such as Coca Cola and Marlboro do not change their strategies. McDonald's makes minor changes to its products. Nike makes even more changes. There are no right answers.

Place

All customers want to have product delivered when they want, where they want and in a manner in which they wish to pay for it (Kotler, 2003 and Pride and Ferrell, 2006). Americans seem to prefer large department stores, witness the growth of Wal-Mart. In Japan, there seems to be a decided preference for the smaller retail store. Whether this is an actual cultural preference or it is mandated by law, is beyond the scope of this paper. If the organization does not want to invest in a sales office in a new country, how should it select a distributor for the products? This is a major issue for successful companies. Successful companies are encouraged to use their established business model when they go overseas because that is what brought them success in the first place. However, this does not necessarily mean to select the distributor who speaks the same language as the vendor. In many areas English is widely used and acceptable for international business but it may not be the appropriate local business language. If English is not the appropriate language, then how should the organization select an appropriate business partner to distribute the products? This issue is especially difficult if the answer is a different language from the selling organization. How will information between the two parties be exchanged?

Promotion

Promotion is the communication of information about the organization or its products to its customers. One of the aspects of promotion is personal selling. How to select a sales person in a different country? What are the characteristics? Again, the characteristics may be somewhat influenced by culture. In America the sales person is expected to be independent and expected to thrive on recognition as "Salesman of the Year" otherwise why would many companies have the award and why would they

have sales contests? However in Japan, since according to Hofstede (1997), it is a collectivist society, a successful salesperson would not want to be identified as 'better' than his peers. In large homogeneous countries, ethnocentrism is not an issue but in other countries it may have a very large impact Calor and Beamish, 1994. So the question arises, who should sell the products in other countries?

The next issue is gender. In many places gender is not an issue for sales people although from the perspective of the purchasing manager (Dion, Easterling and Javalgi, 1997), remains an issue in America. In the FTAA areas gender appears to have been an issue in the past. Whether it will be an issue remains to be seen. Aggressiveness is considered by many sales managers to be a desirable trait of successful salespeople. However research conducted in Canada on 38 organizations indicated aggressiveness is not acceptable (Honeycutt and Ford, 1996). Other characteristics of successful salespeople do not necessarily transfer very well from country to country. This will be an issue that must be addressed if the FTAA organization wishes to be successful outside its own country.

Even the selling process in different countries varies. According to Honeycutt and Ford in their article about hiring and training a worldwide sales force (1996), in America, the standard is to ask probing questions, present benefits and then close the sale. In other countries this process is different. For example in India it is common to simply discuss specifications rather than spend time uncovering needs. In America, many sales organizations bring in a 'closer' to ensure the business is won. This would be an anathema in parts of Europe and in Asia. Also in America it is common for the sales person to ask why s/he lost the business. This would be considered an insult in Japan. In sum, the FTAA will require a major change in marketing for almost all organizations in the region - not only those that wish to be grow but also the ones who wish to survive.

Integration of Distributed Services

FTAA will cause major disruptions and rethinking of supply chain management issues for the organizations who decide to move their manufacturing to areas where it makes economic sense to build the product. Typically organizations build products near their major competitors, as was stated in number 5, above. However when organizations have the opportunity to do so, they often use other selection criteria such as the cost and the availability of appropriate labor, access to raw materials, financing, infrastructure when deciding where to build products. If organizations decide to move their manufacturing into different countries within the FTAA or even outside of it, a whole host of supply chain management issues arise.

Supply chain management is comprised of the value or demand chain and logistics. The former is how a firm structures its internal and external relationships across functional areas to receive products from its vendors or deliver products to its customers. Logistics is how a product moves from point A to point B within the alternative nodes of this chain. The supply chain of a company in a small country may be quite simple. It may consist of the organization shipping its output to a customer in another town. Or it may be as complex as Wal-Mart. Wal-Mart trucks seem to be constantly on the road picking up products at its vendors and delivering

these products to centralized Wal-Mart distribution centers around the world. Other Wal-Mart trucks then take products from the distribution centers and deliver them to the retail stores. Many of these trucks are mini-distribution centers themselves. Scheduling and routing the trucks between vendors, distribution centers and retail stores is difficult enough but add to that the necessity of knowing where each product in the various inventories is at all times at all locations is extremely complicated.

This is not to say that all organizations in the FTAA environment will have to be as sophisticated as Wal-Mart but they will have to manage on time delivery to and from their manufacturing plants that are not necessarily within their own country. If the customer is across town from the factory, this is not a problem. However if there are multiple factories making different products in different countries, major complexities occur. The typical customer would rather receive his order from one location nearby. If one part is made in country A, and one in country B, and still another part s/he has ordered comes from country C, the question becomes: how to deliver to the customer? Would the customer wish to import products from the three different locations? Or, would s/he prefer to receive one consolidated order with no back ordered items. It seems intuitive that the customer would prefer the latter.

Inventory

How to receive semi-processed product from internal and external vendors into the final processing facility 'just-in-time' to maintain a lean production operation while efficiently delivering all products on time without back orders? The tool to achieve this is both complicated and necessary, that is - inventory. Inventory is necessary in order to minimize the impact of uncertainty – uncertainty of delivery of raw material and components and uncertainty of customer demand. Many factories have a warehouse where inventories of raw materials, whether from outside vendors or their sister factories in other locations are consolidated to 'feed' the production process. Factories employing the Make to Stock business model also have a warehouse of finished goods inventory where products are stored until they are ordered by customers (Bowersox, *et al*, 2002). Oftentimes this warehouse also carries finished goods inventory shipped from sister factories in order to provide consolidated shipments to customers nearby.

Where to maintain these inventories and what level of support will they provide? These are not trivial decisions. The carrying costs of inventory can be quite significant. Bowersox, *et al*, (2002) define carrying costs as capital (interest rates), taxes, insurance, obsolescence and storage (Donald Bowersox, David J. Closs, and Bixby Cooper). 2002). If the inventories are warehoused in the wrong places, customer service may suffer and costs may be higher. The FTAA will allow organizations operating within its area considerably more freedom but at a potentially higher cost.

Transportation Management

Inventories are important but the next step is to get the material in the inventories to the customer whether this is moving raw materials from the vendor to the factory or from your factory to the customer. Again, if the organization is simply shipping to a

customer across a small country, perhaps a simple PC program highlighting the most expeditious route is sufficient. However, if the factory is in another country just hours away by air or weeks away by sea, the answer is not that simple or obvious. The following example may illustrate this point; ocean freight is relatively inexpensive when compared with shipment costs by air. However, if the organization is shipping high-value products, perhaps the saving in shipping is more than offset by the cost of capital. For example, a shipment of products worth \$1 million could save more than \$10,000 in cost of capital to the exporter by shipping the goods by air.

Once the most cost-effective logistics decisions have been made for each product, then the next complicated issue arises: How to integrate air, ocean and land freight together into a single system? For example, if one factory has a delay, how to get the material to the warehouse in the customer's country in time to be consolidated to ship complete to the customer? A minor delay in production may result in the necessity to ship by air freight instead of ocean freight. Although the supply chain management issue is complicated by the FTAA, it provides serious marketing opportunities for the organizations that manage to do it well. As mentioned above, place one of the four elements in the marketing mix, frequently is as important as product in the decision by a customer to purchase a product. If the organization can deliver products on time, in the right quantities to the customer, and another organization cannot do so, the organization with the good supply chain management system will win the business. This is seen daily by the growth of Wal-Mart.

Conclusion

The Free Trade Area of the Americas is indeed a timely effort in an age of growing multilateralism. Besides several institutional issues, there are numerous forums constantly engaged in vehement opposition to the formation and functioning of the free trade. In our estimate, the waves of opposition will probably cleanse the nationally fragmented systems and bring cohesiveness among diverse democracies.

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