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## UNILATERAL AND RECIPROCAL TRADE REFORM IN LATIN AMERICA

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The economic landscape of Latin America in 1980 had been shaped by decades of protectionism and import-substituting industrialization. Although Chile initiated wide-ranging trade reforms in 1974, the early results had done little to encourage emulation by other nations in the region, as Chile endured years of double-digit unemployment. Argentina had also reduced trade barriers beginning in 1976. However, effective protection rates remained high, and persistent macroeconomic instability undercut any efficiency gains that trade reforms might otherwise have generated. Mexico and Uruguay had likewise started to liberalize trade in the late 1970s. But each of these countries again tightened import restrictions in the early 1980s. Only in Chile did trade remain significantly less distorted than prior to initiation of reforms, and even there, visible gains still fell short of signaling the clear superiority of the new market-oriented policies. Meanwhile, other countries in the region responded to the debt crisis of 1982 with further increases in trade barriers. By the middle of the decade, Latin America's external sector was the most distorted in the world (Edwards 1995).

Yet despite the decidedly mixed experience of the avant-garde, and notwithstanding significant increases in protection throughout the region in the wake of the debt crisis, the policy tide was beginning to turn. Only a few years later, greater openness had become the norm in Latin America rather than the exception. Still more recently, even Brazil--the region's most notable laggard with respect to trade reform as well as macroeconomic stabilization--succeeded in dismantling some of the inward-looking policies that insulated its economy from foreign competitors for more than a

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generation. By the mid-1990s, the region's move toward greater openness was no longer in doubt; the key question for Latin American policymakers was less *whether* to pursue an outward-oriented policy than *how* to achieve and sustain the required policy environment.

What accounted for the wave of trade liberalization that swept over Latin America in the 1980s and 1990s? One important force underlying the trend was a shifting consensus among mainstream economists regarding the appropriate role of trade policy in promoting development. Professional opinion in the 1950s and 1960s largely favored import substitution, and this approach was implemented throughout Latin America with the enthusiastic support of bilateral and multilateral aid agencies. But subsequent empirical research, including the landmark OECD and NBER projects on foreign trade and economic development, called the old conventional wisdom into question (Little, Scitovsky, and Scott 1970; Bhagwati 1978; Krueger 1978). The studies' conclusion, that a liberalized export-promoting trade regime is more effective than import substitution in accelerating economic development, gained further credence from the conspicuous success of export-led growth in several East Asian economies (Krueger 1997). Closer to home, the collapse across Latin America of development strategies based on import substitution and massive state intervention, together with Chile's takeoff into sustained export-led growth, pushed political leaders to embrace the opening of international trade and other market-oriented reforms (Edwards 1995).

Notwithstanding this broadly shared epiphany, the precise stimulus for and political-economic context of trade reforms in Latin America was as varied as the character, timing, and extent of the reforms themselves. A few countries unilaterally (autonomously) eliminated trade distortions as one element in a broad program of reforms (Chile, Bolivia). In other cases, liberalization was undertaken in conjunction with a regional initiative (Central American Common Market, Andean Trade Initiative, NAFTA, Mercosur). Reformers were also encouraged by strong external incentives from the U.S. government (Caribbean Basin Initiative, Section 301) or from the World Bank and International Monetary Fund (Brazil, Costa Rica, Colombia). Thus, even actions that on the surface appear to be unilateral may have entailed some form of cross-reciprocity.<sup>2</sup>

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<sup>2</sup> Rather than coordinated reduction of trade barriers in two or more countries, cross-reciprocity links trade reform in one country to other types of anticipated benefits. Most common is some form of financial assistance, e.g., structural-assistance lending, that helps to offset the immediate political and economic costs of liberalization.

Some countries also initiated reforms in order to qualify for membership in a trading group with established norms, as occurred in Mexico's preparation to join the General Agreement on Tariffs and Trade (GATT).<sup>3</sup> New members liberalized partly to benefit from the lower most-favored-nation (MFN) tariffs negotiated in past rounds of multilateral negotiations. Similarly, late reformers may have been motivated partly by their improved access to export markets in countries that had already liberalized unilaterally. These situations might be characterized as intertemporal reciprocity in the sense that one country's willingness to liberalize has been increased by the earlier liberalization of partner countries. However, the rapid spread of liberalization across Latin America has alternative explanations that involve no implicit reciprocity. One is the demonstration effect of successful early liberalizers, most notably Chile. Some countries may also have engaged in a process of competitive liberalization, reducing trade barriers and implementing other market-oriented reforms in an effort to attract or retain footloose manufacturing investment (Bergsten 1996). A final explanation views the debt crisis of the early 1980s as a common stimulus affecting a number of countries in a similar way: conditions of "deep economic crisis...relegated distributional issues to second place" (Rodrik 1994).

The suggests that policy debate in Latin America in the 1990s no longer centered on the relative merits of import-substituting industrialization versus export-led growth. That traditional battle was over. Every Latin American country was looking for ways to expand exports, each instituted trade reforms, and some committed to further market-opening measures in the years ahead. But even before the mid-1980s there was no scarcity of trade reform in Latin America. On the contrary, some countries in the region had already embarked on multiple prior episodes of liberalization. In almost every case, however, implementation delays and outright policy reversals halted the reform process in its tracks before the anticipated gains in productivity and growth could be realized. What made the period after 1985 different was not only that more countries liberalized, but also that fewer of the reforms were reversed subsequently.

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<sup>3</sup> By the mid-1990s, all Latin American countries had joined the GATT or its successor, the World Trade Organization, and many had reduced or eliminated some trade barriers (especially nontariff measures) in the process. However, although eight Latin American countries participated in the Uruguay Round of multilateral trade negotiations, none offered significant tariff cuts as part of the round's "reciprocal" tariff concessions (Finger, Reincke, and Castro 1997).

Implementation of outward-looking policies sometimes helps to establish a "virtuous circle" of liberalization through resulting economic and political changes (Krueger 1993). For example, growth of the export sector at the expense of import-competing production raises the political strength of exporters and is thus likely to increase domestic support for liberalizing imports of capital equipment and other required inputs. In other cases, however, resulting economic and political changes undermine the viability of the reforms rather than reinforcing them. In fact, a pattern of liberalization followed by tightening was typical of Latin America during the 1970s and early 1980s. A prolonged period of high unemployment, a noticeable increase in income inequality, or deterioration of the current account are among factors that raise domestic pressure for reversal of liberalization.<sup>4</sup>

Why were the post-1985 trade reforms less susceptible to reversal? Several important developments may help to explain the increased viability of Latin American trade reforms. The first is the increasing weight of evidence in support of outward-oriented reforms as an effective means of promoting growth. An important second factor is improved macroeconomic management, and especially the dramatic reduction of inflation rates throughout the region.<sup>5</sup> Excluding Brazil, the average rate of inflation in Latin America fell from about 300 per cent in 1980-90 to 31 per cent in 1991-96 (Burki and Perry 1997). Brazil's successful stabilization program reduced inflation from about 2700 per cent in 1994 to 18 per cent in 1996 and less than 10 per cent in 1997. Earlier heterodox approaches had achieved only limited success in battling chronic inflation, and their reliance on administered prices and interest rates was fundamentally incompatible with market-oriented reforms (Thomas, Nash, et al. 1991). Moreover, World Bank and IMF resources were increasingly deployed in support of outward-oriented reforms. These external resources allowed reform-minded governments to soften unfavorable initial effects of the new policies and thus to defuse potential pressure for policy

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<sup>4</sup> Rodrik (1994) highlights distributional conflict as a limit to sustaining openness. However, a World Bank study concludes that a balance-of-payments deficit was the primary factor in eight of 14 countries whose liberalizations were subsequently reversed; of five countries in which no reversals occurred, only one had experienced balance-of-payments difficulties (Michaely, Papageorgiou, and Choksi 1991).

<sup>5</sup> Rodrik (1994) also suggests that trade reforms included in broader policy packages benefited from a kind of halo effect. Once inflation was firmly under control, some of the success was attributed--rightly or wrongly--to open trade policies. Conversely, failed stabilization is often associated with reversal of trade reform (Rajapatirana, de la Mora, and Yatawara 1997), although this may be in direct response to an associated balance-of-payments problem.

reversal. A World Bank study (Burnside and Dollar 1997) confirms that providing multilateral aid to developing countries with "sound policies" increases the probability that reforms will persist.

A final explanation links sustained trade reforms to the proliferation of regional trade agreements (RTAs) that accompanied MFN liberalization beginning in the mid-1980s. Because unilateral liberalization and formation of regional trade areas are associated with significantly different adjustment paths, they differ also in their ability to withstand the inevitable domestic pressure for reversal. Membership in an RTA may therefore allow some countries to go forward with market opening even when unilateral liberalization faces insurmountable political obstacles. To be sure, the potential for this kind of complementarity depends crucially on the underlying objectives of regional cooperation. The inward-oriented Latin American RTAs of the 1960s and 1970s were explicitly intended to foster import substitution at the regional level and were thus antithetical to unilateral liberalization by member nations. In contrast, regional agreements of the 1980s and 1990s sought to enhance the international competitiveness of their members, with the ultimate goal of achieving full integration into global markets.

The purpose of this paper is to document Latin America's re-opening to international markets, to assess the role of unilateral trade liberalization in the region's move toward openness, and to shed light particularly on the zeal with which Latin American countries pursued regional trade initiatives. The paper identifies a number of obstacles to sustaining trade liberalization and ways in which successful liberalizers in Latin America were able to overcome them. The focus is trade reform as an ongoing process, including the packaging of reform measures, their timing and sequencing, and the political- economy issues central to the viability of reforms in progress.

### Documenting Trade Reform in Latin America

To evaluate Latin America's progress toward openness, an important first step is to consider the large menu of policy changes potentially included under the general heading of trade liberalization. Everyone can agree that Chile's dramatic across-the-board tariff cuts in the 1970s and 1980s were

indeed liberalization. But outward-oriented reforms in a number of Latin American countries focused on creating new incentives for *exporting* (much as was done in countries as diverse as South Korea, Mauritius, and Morocco on other continents), and especially for nontraditional export products and markets, as in Costa Rica and Brazil. Moreover, it was not unusual for a country to maintain import-substitution policies in some industries while offering export incentives in others, or even to tax traditional exports while promoting nontraditional exports, as Brazil and Argentina did. Finally, most countries in Latin America reduced MFN barriers to imports while at the same time making still larger cuts within regional arrangements.

Because many policy variables potentially affect a country's trade, even the direction of the net change in openness or outward-orientation can be less than obvious. The NBER study of trade reform in developing countries classifies as liberalization any policy change that reduces the traditional anti-export bias of a country's trade regime (Bhagwati 1978, Krueger 1978). Revisionist interpretations of the paradigmatic East Asian experience (e.g., Rodrik 1995) suggest that an active government role rather than merely "getting prices right" was central to the export-led growth strategies of South Korea and Taiwan; by the Bhagwati-Krueger criterion even explicitly targeted export incentives qualify as liberalization.

Baldwin (1989) distinguishes between *incidence-based* measures of policies affecting trade, such as average tariff rates, and *outcome-based* measures, usually the relative size of trade flows. Because many factors apart from policies toward trade affect openness as measured by the relative importance of trade, outcome-based measures are useful in evaluating change in the openness of a single country rather than in making comparisons across countries. Moreover, a country may reduce its tariffs, thus appearing to liberalize according to one standard incidence-based measure, yet maintain import licensing arrangements or exchange controls that in effect nullify the reduced import barriers. In this case, an outcome measure such as the ratio of trade to gross domestic product (GDP) will show little progress.

Pritchett (1996) proposes three concepts of trade liberalization or outward orientation. *Neutrality* refers to a reduced bias toward production of import-substitutes, *liberality* to a lower degree

of market intervention, and *openness* to an increase in trade intensity.<sup>6</sup> Comparing alternative summary measures of outward orientation from the empirical literature on growth and openness, Pritchett shows the indicators to be almost completely unrelated in cross-country data for less-developed countries. This finding suggests that openness has several dimensions; countries making the best progress according to one measure will not necessarily look as good in terms of another.

Whereas Chile's broad reductions in tariffs and nontariff barriers qualify under all three of Pritchett's concepts, some export-promotion efforts in East Asia improved neutrality and openness while increasing rather than reducing the extent of market intervention. As elsewhere, the move toward outward orientation in Latin America was far from synonymous with *laissez faire*. Although most Latin American countries liberalized trade while at the same time pursuing other market-oriented reforms such as privatization and deregulation, only in Chile was trade reform imbedded in an all-encompassing movement toward free-market policies. However, tables 1-4 suggest substantial progress according to all three types of indicators.

Tables 1 and 2 display several indicators of import policy reform in eleven Latin American countries for which detailed information is available on a comparable basis.<sup>7</sup> Table 1 shows both weighted<sup>8</sup> mean tariff rates and weighted mean total import charges, the latter including a range of "paratariffs" that further raise the cost of imports. Between the mid-1980s and the early 1990s, mean tariff rates fell in nine countries. The exceptions are Mexico and Paraguay, which had the lowest mean rates in the initial period. Mean total charges also fell, sometimes dramatically, in nine countries. Here the exceptions are Chile and Mexico, both early reformers that had already reduced import

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<sup>6</sup> Broad reductions in import barriers, e.g., across-the-board tariff cuts, generally improve both neutrality and liberality. However, application of additional interventions may, for second-best reasons, improve neutrality while reducing liberality. Improvements in either neutrality or liberality may in turn raise openness as measured by trade flows. But openness measures such as the value of exports as a share of GDP are also affected by exogenous changes in world prices.

<sup>7</sup> Inter-American Development Bank (1996) provides qualitative indicators of increased openness for 25 countries in Latin American and the Caribbean. The report concludes that virtually all the countries in the region participated in the trend: "The region's trade and foreign exchange systems are currently [in 1996] freer than they have been since the period before the Great Depression."

<sup>8</sup> In UNCTAD data, sectoral rates are weighted by product shares in *world* trade. Compared to the usual practice of weighting by shares in the country's own imports, this procedure avoids a downward bias in the weight given to sectors with unusually high protection, i.e., ones more protected in a given country than the global average for the industry. However, there is still a downward bias for sectors highly protected on average worldwide, such as steel and autos.

barriers before the start of the period. However, given Chile's reputation as the region's liberalization superstar, it is interesting that its mean total import charges are the highest of the group and nearly double its mean tariff rate alone. The table likewise shows dramatic declines in the incidence of nontariff measures (NTMs), including quantitative restrictions. The modest increase in Paraguay's weighted mean tariffs may reflect tariffication of remaining NTMs in compliance with Mercosur and WTO commitments, rather than an increase in overall protection. The large decrease in Paraguay's mean total import charges supports the conclusion that its overall protection was declining.<sup>9</sup>

Table 2 shows that average minimum and average maximum tariff rates fell in nine countries. Mexico and Paraguay are again the exceptions, although with final rates in the same range as other countries in the group. Because the inefficiency associated with protection comes in part from "chaotic" incentives (Bhagwati 1978), tariff reform is most beneficial when it is associated with a reduction in the dispersion of rates as well as in their height. Chile's flat tariff schedule gives most domestic production a uniform advantage over competing imports; a flat schedule implies that effective protection rates are the same as nominal rates. Dean, Desai, and Riedel (1994) report sizeable reductions in tariff dispersion (standard deviation) associated with trade reforms in Argentina, Brazil, and Costa Rica, along with a small increase in dispersion for Peru. A cruder measure of dispersion is the ratio of the average maximum tariff rate to the average minimum rate. The higher the ratio, the greater is the possibility that effective protection rates have been maintained or even increased despite reductions in both averages. Table 2 shows that the ratio fell in only four of nine countries, although these falls occurred in the countries with the highest initial ratio. The final ratios of average maximum to average minimum tariff rates range from close to 1 in Bolivia and Chile to 1.9 in Brazil.<sup>10</sup>

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<sup>9</sup> Although cuts in tariffs are often regarded as an essential element in trade liberalization, less than half of the liberalization episodes in a major World Bank study included tariff reduction; in contrast, reduction in the severity of quantitative restrictions was almost always included (Michaely, Papageorgiou, and Choksi 1991).

<sup>10</sup> In principle, unification of tariff schedules could be accomplished by raising some especially low tariffs. However, actual tariff unifications in Latin America and elsewhere have been achieved almost exclusively through tariff reductions (Michaely, Papageorgiou, and Choksi 1991).

In addition to direct restrictions on trade flows, an important dimension of outward orientation broadly conceived is the foreign-exchange regime. Devaluation of an overvalued currency fits the Bhagwati-Krueger definition of trade liberalization since it reduces the bias against exports. Similarly, the composite binary measure of openness adopted by Sachs and Warner (1995a) classifies a country as closed if it meets even one of several criteria of significant insulation from global market forces, including a large differential between the official and black-market exchange rates as well as the extent of policies directly limiting trade. In the Sachs-Warner scheme, removal of trade barriers alone is insufficient to qualify as opening if the official exchange rate is kept so overvalued as to prevent development of export activities along lines of comparative advantage. Other analysts focus on changes in trade policies only and treat exchange-rate policy separately if at all.<sup>11</sup>

All eight Latin American countries studied by Dean, Desai, and Riedel (1994) reduced the extent of intervention in foreign-exchange markets after 1985, eliminating multiple exchange rates and abolishing most exchange controls. Moreover, the countries with the highest black-market premiums prior to reform achieved the largest reductions in their premiums. For the region as a whole, the average black-market premium fell from 72 per cent in 1989 to 2 per cent in the mid-1990s (Inter-American Development Bank 1996). Table 3 shows that the black-market premium fell, often dramatically, for all countries for which 1995 data were available.

Exchange controls are almost always associated with maintenance of an overvalued exchange rate, although the black-market premium is likely to overstate the extent of overvaluation. Liberalization of the exchange regime is therefore typically accompanied by a nominal devaluation of the currency.<sup>12</sup> Adoption of a more-liberal exchange regime also tends to increase allocative efficiency in international transactions and to reduce efficiency losses due to rent-seeking. Michaely, Papageorgiou, and Choksi (1991) note that devaluation has been a universal element in stabilization

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<sup>11</sup> As in the NBER project, the binary Sachs-Warner openness measure relies on subjective evaluation of information from diverse sources. Other researchers attempting to establish statistical links between trade and growth have used a variety of statistical measures of openness. See Harrison (1996) for a survey. Openness measures based on export or import volume or on divergence between domestic and foreign prices implicitly consider effects of both trade and exchange-rate policies.

<sup>12</sup> But liberalization cannot ensure that an exchange rate consistent with purchasing power parity will be maintained over time. As discussed below, successful reforms may promote capital inflows and an associated real appreciation.

packages and a "common—sometimes crucial—instrument of trade liberalizations," even those not associated with stabilization programs.

Most Latin American countries implemented large real devaluations in the wake of the debt crisis (Edwards 1995), thereby shifting domestic production in favor of tradable goods and promoting export growth. But as these countries succeeded in implementing and sustaining market-oriented policy reforms, inflows of private capital from abroad often contributed to real appreciation and slower export growth. Table 3 shows that real effective exchange rates appreciated between 1990 and 1995 for seven of the eight countries in the group for which the International Monetary Fund publishes such a rate, the exception being Bolivia. In the cases of Colombia and Chile, capital controls were applied to limit certain types of inflows and thus the associated real appreciation. A persistent tendency to real overvaluation was likewise a problem in Argentina, Brazil, and Mexico, each of which used a nominal-anchor strategy to combat domestic inflation.

Table 4 compares several outcome indicators of openness for twelve Latin American economies. Of the twelve countries, ten experienced faster growth of export volume from 1990 to 1995 than in the preceding decade. Export growth slowed slightly in Colombia and Brazil, although in both cases exports grew at a faster rate than GDP over the entire period. However, the share of exports in GDP rose in only seven of the twelve countries, declining modestly for four and dramatically for Peru. The seeming paradox of a fall in export share over a period in which the average growth of exports is greater than that of GDP reflects differences in the two types of measures. The export share in GDP is calculated using current price data, while growth rates are calculated using constant prices and thus measure changes in volume rather than value. Relative prices of most agricultural and mineral raw materials declined sharply between 1980 and the mid-1990s. With primary commodities accounting for more than four-fifths of its exports, Peru experienced a large deterioration in its terms of trade over the period.

Because the ultimate goal of policy reform is to accelerate economic growth, the most important outcome measure is the rate of growth. Of course, many types of policy change contributed to Latin America's improved overall economic performance. Perhaps most important was macroeconomic stabilization. Even within the category of efficiency-enhancing structural reforms,

trade liberalization is only one of a broad spectrum of market-oriented policies implemented since the mid-1980s. Still, the data confirm that Latin America's far-reaching trade reforms were at least consistent with higher overall growth rates. Eleven of the twelve countries experienced higher average annual GDP growth in the period after 1990. The average growth rate was the same in both periods for Brazil. For the region as a whole, the weighted average of the annual growth rates was 3.2 per cent from 1990 to 1995, compared to 1.7 per cent over the previous decade (World Bank 1997). Moreover, the aggregate figures include the slow growth in Mexico and Argentina in the wake of Mexico's December 1994 peso crisis. With a strong recovery in those economies, the regional average reached 3.5 per cent for 1996. But higher economic growth in the 1990s did not necessarily translate into reduced unemployment (Burki and Perry 1997). The region's average unemployment rate in the mid-1990s was in fact higher than in the 1980s, reflecting sharply higher unemployment in Argentina and smaller increases in Mexico and Venezuela.

Table 5 dates the initiation of trade reforms in the major South American countries plus Mexico and Costa Rica as determined in several studies using alternative criteria. The table also classifies the *initiation* of reforms as representing unilateral liberalization or influenced by some combination of (trade) reciprocity, cross-reciprocity, and/or intertemporal reciprocity. Reciprocity is based on a trading-bloc affiliation at the time reforms were initiated, although this does not establish a causal link. A motivating role of cross-reciprocity is cited by Michaely, Papageorgiou, and Choksi (1991) for Argentina (1967) and Peru (1979). Thomas, Nash, et al. (1991) cite external financing between 1979 and 1987 from the World Bank and the IMF as "intended to facilitate the policy change" in Argentina, Brazil, Chile, Colombia, Costa Rica, Mexico, and Uruguay. Edwards (1995) estimates that nearly four-fifths of World Bank programs from 1983 to 1989 included conditions relating to trade-liberalization goals. He emphasizes, however, that the role of the international organizations and the U.S. Treasury in "forging the new consensus" on the need for openness may have been as important as conditioning release of funds on specific reforms. Because of the evolving views of Latin American leaders, reforms implemented sometimes went far beyond those specified in loan conditions (e.g., Mexico, Colombia). Table 5 attributes possible motivating factors only to the *initiation* of reform. From the late 1980s onward, all the reformers benefited from after-the-fact external technical and

financial support from the World Bank and IMF. By early 1996, all twelve countries (along with all remaining Latin American countries) had joined the WTO (nine were already GATT members in 1994). By the mid-1990s, each of the twelve had also entered into at least one regional trade arrangement.

### Liberalization as a sequential process<sup>13</sup>

Why were most nations in Latin America able to achieve and sustain an open economy while other developing countries--often guided by the same received wisdom and even the same advice from the same foreign experts--failed to do so? The answer lies in the complex interplay of economics and politics that is central to the process of liberalization. Trade policy is inherently endogenous, shaped by underlying political forces. The economic results of implementing each new policy alter the political balance within a country, thus strengthening or weakening the position of reformers.

To consider the underpinnings of successful and sustained trade reform, it is helpful to divide the process of liberalization into four sequential components: (1) the design of a policy package; (2) its acceptance and endorsement by top policymakers; (3) its implementation in specific policy measures and their administration; and (4) the economy's response to changed incentives. The last component in turn influences the degree of support from the policy community and the public, completing the political-economic cycle. Correspondingly, a reform package may fail for several reasons. First, the policies themselves may be poorly conceived or inappropriate to the country's economic or political circumstances. Second, the package, though well designed and appropriate, may nonetheless fail to gain the support of a country's political leadership. Third, even a package supported by top policy officials may be aborted if the relevant legislative and administrative bodies are unwilling to implement it. Finally, elements in the policy environment may prevent markets from responding appropriately to the changed incentives.

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<sup>13</sup> This section is adapted from McCulloch (1999).

The record of Latin America shows a general progression over these stages. In the early 1970s, doubt still remained concerning the best policies to follow; industrialization via import substitution continued to enjoy wide support among Latin American economists and policymakers. To some, the domestic dislocations from the first oil shock vividly demonstrated the potential danger of greater integration into international markets. By the late 1970s, the intellectual case for open markets was ascendant, but many Latin American policymakers remained unconvinced. In the early 1980s, governments rolled back earlier trade reforms in response to debt problems. But by the late 1980s, trade reforms once initiated began to stay in place, at least in countries that had managed to achieve macroeconomic stability.<sup>14</sup> The most important “late” trade reformers, i.e., countries that continued to reverse earlier liberalization, were Argentina and Brazil, both of which experienced repeated failures of macroeconomic stabilization efforts. It is noteworthy that the regional macroeconomic dislocations associated with the December 1994 devaluation of the Mexican peso did not lead to a major rollback of Latin American trade reforms. The only country to retreat temporarily in 1994 and 1995 from earlier reforms was Venezuela (Inter-American Development Bank 1996).

### Getting started

In Latin America, the fundamental ideas for reform were typically imported. These ideas were assembled and put forward by foreign experts and a new generation of domestic policymakers trained in the United States.<sup>15</sup> But to have a reasonable chance of being implemented, a reform initiative requires support from *some* of a country’s top policymakers. Drawing on four decades of experience in advising Latin American governments, Harberger (1993) concludes that the right advice is not

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<sup>14</sup> In a chapter titled “The Emergence of a New Latin American Consensus,” Edwards (1995) thus sums up the sea change in economic thinking during the 1980s and early 1990s: “The once-dominant view based on heavy state interventionism, inward orientation, and disregard for macroeconomic balance slowly gave way to a new paradigm based on competition, market orientation, and openness. In 1992 the United Nations Economic Commission for Latin America and the Caribbean (CEPAL), a historical supporter of inward-looking and government-led development, recognized that the most appropriate course was now to emphasize openness...” Bruton (1998) provides a detailed intellectual history of “the new orthodoxy” of outward orientation but expresses his doubts regarding its adequacy as a full solution to the problems of underdevelopment.

<sup>15</sup> Not necessarily or even mainly at the University of Chicago, as Jose Pinera, a Chilean free-marketeer educated at Harvard, emphasizes (Pinera 1994).

enough. Successful economic policies “would in all likelihood have failed (or never got started) but for the efforts of a key group of individuals, and within that group, one or two outstanding leaders.” In a number of cases, this core group consisted of young U.S.-trained economists. Williamson and Haggard (1994), summarizing views of several development experts, likewise cite the need for visionary leadership and a “sense of history.” In their own opinion, however, great vision is not always required. Given a crisis situation, any sensible leader will see the immediate political benefit of a major change in policy direction.<sup>16</sup>

Empirically, crisis conditions do sometimes provide the spur needed for major reforms (Chile in 1974, Argentina in 1989, Peru in 1990). Rodrik (1994) argues that crisis conditions push distributional issues into the background and thus allow trade reforms to go forward. But action taken in response to a crisis is not necessarily a move toward greater openness. On the contrary, many Latin American countries rolled back earlier trade reforms in response to the oil shocks of the early 1970s and again during the debt crisis of the early 1980s. Likewise, macroeconomic crisis appears to be the most common reason for the reversal of liberalization by individual Latin American countries (Rajapatirana, de la Mora, and Yatawara 1997). In other cases, liberalizers initiated reforms without waiting for a full-blown crisis to materialize under old policies (Costa Rica in 1986, Colombia in 1984).

Successful reform also requires support from legislators and administrators to ensure its effective implementation. To create the desired changes in economic behavior, the vision of a leader must first be translated into practical policies. However, some governments lack the necessary technical expertise to implement new policies. While help is often available from aid agencies in the OECD countries and from multilateral organizations such as the World Bank and International Monetary Fund, excessive reliance on outside assistance may exact a high price. A key role for foreign experts may alienate local officials and erode their sense of ownership of the new policies. Moreover, critics of reform often take advantage of any prominent foreign role to marshal domestic support for their opposition. The persistent appeal of populist and heterodox economic programs in

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<sup>16</sup> Conversely, Bresser Pereira (1994) attributes the failure of his 1988 inflation-fighting initiative in Brazil to President Sarney’s unwillingness to support the unpopular plan in the absence of an outright emergency.

Latin America (e.g., Peru in 1985, Brazil in 1986) stems partly from their rejection of neoclassical policy advice from foreign, and especially U.S., experts. In 1984, even Chile replaced its band of “Chicago boys” with mainstream advisors who raised tariffs, though a new group of Chicago-trained economists was installed the next year.

A different type of “problem” related to policy implementation is that the administrative burden of a laissez-faire approach is much lighter than that of a dirigiste economic regime. Substantial resistance to market-oriented reforms may therefore come from government officials whose jobs, salaries, prestige, and often opportunities for graft are endangered, as well as from their opposite numbers in the private sector who have learned how to operate profitably under existing policies. Thus, opposition to reform is likely to extend far beyond the firms and workers in protected import-competing sectors.

#### Maintaining broad popular support

Support at the top is necessary but not always sufficient for political sustainability. However, the importance of broad political support depends, especially in the short term, on the form of government. An authoritarian regime may be able to force the population to accept austere policies or to shape public opinion through control over the media. Some development specialists have even raised the controversial notion that early introduction of democratic institutions may doom the prospects for needed economic reforms.<sup>17</sup> Indeed, authoritarian governments launched many of the successful reform efforts in both Latin America and East Asia. In most cases these reforms were not reversed by subsequent democratic regimes.<sup>18</sup> But any new government, whether authoritarian or democratic, may enjoy a kind of honeymoon period during which leaders benefit from greater freedom of maneuver as well as the luxury of blaming unsatisfactory economic conditions on the previous

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<sup>17</sup> Concerning the slow pace of reform in Ecuador, *Trends in Developing Economies 1996* notes the nation’s “long democratic traditions” but also that “considerable political fragmentation and divisiveness makes the pursuit of long-term policies difficult” (World Bank 1996).

<sup>18</sup> If individual voters are unsure whether they will be winners or losers from liberalization, majority voting may reject even a trade reform that benefits the median voter (Rodrik 1996). Myopia and risk aversion exacerbate the problem of getting voters to support efficiency-raising reforms.

regime (Chile in 1974, Argentina and Paraguay in 1989, Peru in 1990). Of course, the new leader is often merely carrying out earlier promises regarding direction of policy change.

The need for broad political support is one explanation for the popularity of reciprocal liberalization in general and of RTAs in particular. The public and even many policymakers take a largely mercantilist view of trade reforms, finding it easy to grasp the benefits from increased exports (typically seen as expanded sales and employment) and accordingly difficult to see the benefits from increased imports. In a reciprocal agreement, the increased imports can be justified as the price of increased exports. But, given this prevalent misunderstanding of the fundamental nature of gains from trade, belief in the benefits of unilateral liberalization requires a major leap of faith.

### Overcoming Obstacles to Successful Liberalization

Trade liberalization is an intensely political subject for two related but distinct reasons. The first is that costs associated with new policies become apparent almost immediately while the gains lie farther in the future. Adjustment costs along the way can mean a period of lower average living standard, even though there are always some who gain immediately from any change in policy. This is one reason why visionary leadership can be key to successful reform. A separate problem is that there are always permanent losers from any liberalization. Moreover, *trade* reform entails an especially high ratio of redistribution to total gains (Rodrik 1994). While there is no way to avoid transition costs or an uneven distribution of long-term costs and benefits, appropriate policies may reduce their extent and thus preserve the political viability of reform.

Commitment to an outward-oriented trade strategy requires complementary supporting policies and conditions. These include transportation and communications infrastructure; access to financial capital and to imported capital goods, raw materials, and intermediate inputs; a well-functioning labor market, and, above all, an appropriate real exchange rate. To the extent that potential exporters respond to profit opportunities offered by the new policy environment, their political influence increases while that of import-competing producers wanes. The result is then to strengthen political

support for liberalization, allowing the reform process to go forward (Krueger 1993). But *will* potential exporters respond? The key to the virtuous cycle lies in the credibility of the new policies, and this in turn rests on the economy's ability to withstand the dislocations of the adjustment period.

### Adjusting to new policies

Liberalizing countries necessarily experience dislocation costs during the period of adjustment to new policies. These dislocation costs are of two main forms: those associated with necessary changes in the composition of durable capital, and those associated with unemployment of labor or other resources. As long as change in policy has not been fully anticipated, the economy will begin from a given stock of durable sector-specific human and physical capital that is no longer optimal. In the new situation, some types of capital will be worth more than their replacement cost, others will be worth less. Trade liberalization will typically reduce the value of capital in import-competing industries and raise the value of capital in current or potential export sectors. If real factor rewards are flexible, these resources can continue to be fully employed as the stock adjusts over time to suit new relative prices. Required changes in the returns to industry-specific factors are largest soon after the new policy comes into force; in the post-liberalization equilibrium following complete adjustment in the stock of sector-specific capital, the market value of any factor must again equal its replacement cost.

In the absence of factor-market distortions, the laissez-faire adjustment process will be socially optimal. In particular, there will be no efficiency gain from speeding up or slowing down the process through government policy, although there may be political reasons to do so. But factor prices are rarely very flexible in the short run, and other factor-market distortions are likely to be present as well. Some resources will therefore become unemployed during the transition period, necessarily raising the social cost of adjustment and thus undermining political support for the liberalization program. These temporary dislocations would seem to bolster the case for some kind of government adjustment assistance program to speed the movement of resources into expanding sectors.

In practice, however, the economic benefits from adjustment assistance appear to be slim. Where adjustment assistance is offered to workers displaced by trade liberalization, it usually takes the

form of a social safety net that is more generous than the one covering workers displaced for reasons other than increased foreign competition. Providing such special benefits may be good politics—allowing liberalization to go forward in the face of strong opposition from workers. A less-benign type of adjustment assistance takes the form of subsidized loans and technical assistance to trade-impacted firms. These measures retain resources in declining sectors and thus tend to delay rather than facilitate adjustment. In either case, the primary motive for such policies is to defuse political opposition to socially desirable liberalization.<sup>19</sup>

Development economists formerly counseled gradual change in policy as a means of reducing costs of adjustment (e.g., Little, Scitovsky, and Scott 1970). This is another area where conventional wisdom has changed in the light of experience. In practice, gradual policy changes allow more time for opponents of liberalization to marshal their forces. Liberalization delayed can therefore mean liberalization cancelled. Chile's long-lived reforms began as shock therapy, not gradualism. In contrast, when Argentina in the 1970s announced a schedule of gradual reforms, firms expecting to be negatively affected lobbied successfully to cancel the planned tariff reductions (Edwards 1995). Such observations may help to explain why late reformers in Latin America moved much faster than nations that opened up earlier. Edwards (1995) points to "a clear change in what is perceived to be abrupt and rapid...what fifteen years ago [in Chile] were seen as brutally fast reforms are now considered to be mild and gradual liberalizations." Colombia cut average import tariffs by 65 percent in one year, going from an average of 34 per cent in 1990 to 12 per cent in 1991. Peru eliminated quantitative restrictions in "one bold move" and cut tariffs from an average of 110 per cent in 1990 to 15 per cent in 1992. Table 6 shows that the most recent liberalizations in eight of twelve countries are classified as shock trade reforms. Of these, all but one (Venezuela) had been sustained as of 1997.

In other parts of the world, rapid radical reform has also had a better overall record than gradualism. Based on evidence from trade reform by developing countries in the 1980s, often with support from the IMF and World Bank, Thomas, Nash, et al. (1991) conclude that "comprehensive,

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<sup>19</sup> In the United States, the first trade adjustment assistance program was created by the 1962 Trade Expansion Act, which authorized U.S. participation in the Kennedy Round of multilateral trade negotiations. For a number of useful contributions on the theory and empirical record of trade adjustment, see Bhagwati (1982).

intense, and rapid" reform is usually preferable because its benefits are both larger and sooner than under a more gradual approach. To the extent that gradualism gives rise to uncertainty about full implementation, gradual policies may lack credibility. With domestic and foreign investors in doubt as to whether an announced program will ever be fully implemented, the new price signals may elicit little response.

Also undercutting the case for gradualism is recent evidence that the aggregate effect of successful trade liberalization on employment can be relatively small even in the short run. Although workers will be displaced from firms in contracting sectors, much of the resulting job loss can be offset by employment expansion in export industries (Edwards 1995). However, the popular mercantilist accounting of jobs created and jobs lost gives little indication of actual adjustment costs borne by displaced workers, which depend on gross rather than net changes and on worker characteristics. It also takes no account of the real gains from expanded trade--increased efficiency from replacing low-productivity import-competing output with regionally or globally efficient export production.

### Real exchange rates

For an economy adopting an outward-oriented strategy, the most important price to "get right" is the real exchange rate. Appreciation of the real exchange rate undercuts the competitiveness of potential exports across the board and makes imports look cheap relative to their domestic counterparts; increased unemployment and deterioration of the current account result. If the nominal exchange rate is fixed, the usual policy response is a return to protectionist measures; the reversal is often billed as temporary, justified by the need to protect jobs and dwindling international reserves. Recent Latin American trade reforms have almost always begun with a large nominal devaluation (Edwards 1995), yet the single economic factor most likely to sabotage a liberalization attempt once in progress is (a return to) overvaluation of the real exchange rate. Real appreciation often occurs when the exchange rate is used as a nominal anchor in battling domestic inflation. The potential incompatibility of the nominal-anchor strategy with maintaining a viable real exchange rate gives rise to the judgment that macroeconomic stabilization must be achieved before trade liberalization has a

good chance at success. The repeated reversals of trade reform in Argentina and Brazil were linked to failed stabilization programs.

Another threat to an appropriate real exchange rate comes from the capital account. Initiation of a credible reform package may attract new capital inflows. Indeed, the desire to increase inward direct investment is often an important motive for reform. A flexible nominal rate will rise (at least temporarily) as a consequence of capital inflows attracted by the new policy initiative. Under a fixed rate, increased capital inflows will swell reserves, thereby putting upward pressure on the domestic money supply and the price level. In either case, real appreciation is the likely result. This is one reason for the conventional advice that trade reforms should precede capital-account liberalization. However, rather than limiting all capital inflows, developing countries often try to discourage only inflows of short-term liquid capital, thus offering exporters some protection from volatility of the real exchange rate without losing the potential benefits from longer-term investments. Techniques used to limit short-term inflows include minimum maturity conditions, taxes, and reserve requirements on foreign borrowing, as implemented by Colombia and Chile (Burki and Perry 1997).

### Macroeconomic discipline

By the 1990s, most nations in Latin America had finally managed to achieve the degree of macroeconomic stability essential for good economic performance. Until then, structural adjustment policies including trade reform were held hostage by the need to reduce budget deficits and curb inflation. As noted above, battling inflation may produce an overly strong real exchange rate that taxes would-be exporters. Trade reform may also pose a fiscal problem for developing countries, which typically rely on trade taxes for a substantial share of revenue. However, table 4 indicates that all twelve countries covered in this paper reduced their relative dependence on trade taxes as a source of revenue for the central government between the early 1980s and the mid-1990s.

In Latin America, taxes on major commodity exports have traditionally generated a substantial fraction of government revenue. When Argentina eliminated export taxes at the start of the 1990s, improved compliance with income taxes helped fill the resulting gap (World Bank 1996). In other cases, trade reform was carried out in tandem with the privatization of government-owned companies

(e.g., Peru since 1990). Privatization typically produces double fiscal benefits: first from the asset sale, then from avoidance of the budget-breaking operating subsidies often required to keep government enterprises in operation. Import tariffs have also been a significant source of government revenue for most Latin American countries. In principle, a move to a simple trade regime with low uniform trade taxes could raise rather than lower trade's contribution to government revenue, depending on the price elasticity of trade flows and the prior extent of smuggling to avoid high tariffs and burdensome nontariff barriers. Another potential offset is tariffication of quantitative restrictions, a policy change considered to be a move toward trade liberalization because it reduces the role of administrative discretion. Although it boosts tariff revenues, tariffication has the political disadvantage of creating losers (former license holders) without immediately obvious winners. In practice, such offsets have not been sufficient to prevent total tariff collections from falling as trade is liberalized. Some policy analysts therefore argue that the fiscal deficit should be reduced before trade is liberalized (Thomas, Nash, et al. 1991).

### Increased inequality

Regardless of the political regime, the sustainability of any policy package eventually rests on its ability to raise, or at least not to reduce, the resources available to meet the needs of the population. A package that delivers a rising average living standard is obviously easier to sell than a package that requires sacrifice. The yardstick most often used to compare economic success across countries is growth in per capita income (PCI).<sup>20</sup> But the viability of reforms depends not only on aggregate or average gains but also on their distribution. The debt crisis of the early 1980s was associated with a pronounced tendency toward increased inequality in Latin America, but subsequent recovery and reforms reversed this effect, at least for the region as a whole. The income share of the lowest quintile of the population rose from 3.4 per cent in the 1960s to 4.5 per cent in the 1990s, while the income

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<sup>20</sup> This standard is highly but not perfectly correlated with others that give a better picture of changes in the living conditions of a "typical" member of the population, such as infant mortality, longevity, access to clean water, and literacy. Another recent concern not captured by conventionally measured growth in PCI is degradation of the environment, including inefficiently rapid depletion of natural resources. This concern is addressed in the emphasis on *sustainable development*, i.e., development that doesn't mortgage the welfare of future generations.

share of the highest quintile dropped from 61.6 per cent to 52.9 per cent over the same period (World Bank 1997b). Although income inequality remains an important policy concern in Latin America, there is little evidence that market-oriented reforms in the 1980s and 1990s exacerbated the problem.<sup>21</sup>

A previous generation of development economists saw in Simon Kuznetz's inverted-U of temporarily increased income inequality the necessary price of future growth; concentration of income and wealth were assumed to promote essential capital formation by raising the aggregate saving rate. Today this rationalization seems less persuasive. The high saving rates that fueled growth in East Asia were achieved without increases in inequality. Moreover, in a world of internationally mobile capital, domestic saving and domestic capital formation are no longer required to move in lockstep. In Latin America, internationally mobile capital provides a barometer of investor sentiment regarding the credibility of reforms. Countries that achieve stable, market-oriented institutions have been able to supplement domestic saving with private capital inflows from abroad. Although governments rarely appreciate the daily "policy report card" provided by active financial markets, concern about losing foreign investment may very well restrain officials' impulse to adopt policies with short-term payoffs but longer-term costs (McCulloch and Petri 1998). Conversely, while international investors are indeed likely to shun countries without strong market institutions, wealthy Latin American savers are highly resourceful in finding means to move their own financial assets to safe havens abroad. Anecdotal evidence strongly suggests that concentration of income and thus of savings facilitates capital flight. In this case, increased income inequality--whatever its effect on the aggregate saving rate—is likely to reduce the amount of domestic savings available to finance domestic capital formation.

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<sup>21</sup> For a sample of less-developed countries worldwide, Dollar and Kraay (2000) find that openness to foreign trade benefits the poor to the same extent on average that it improves overall economic performance. Improvements in rule of law and fiscal discipline are likewise found to benefit the poor to the same extent as the economy as a whole.

### Skilled versus unskilled labor

In earlier decades, discussion of the potential for temporary or permanent increases in income inequality resulting from liberalized trade centered on changes in labor earnings versus return to capital, especially foreign-owned capital. In the 1990s, attention began to focus more on the observed increase in the gap between earnings of Latin America's skilled and unskilled workers, which some tie to increased openness (e.g., Wood 1997). For a world of two factors, the Stolper-Samuelson theorem predicts exactly this outcome in skilled-labor-abundant countries like the United States. However, the same model also predicts a shift to a lower ratio of unskilled to skilled labor ratio in production, the opposite of what has been observed in most industrial nations. For this reason, Lawrence and Slaughter (1993) argue that skilled-biased technical change rather than trade lies at the heart of the controversial trend. Moreover, the Stolper-Samuelson model predicts a fall in the same differential for unskilled-labor-abundant countries, i.e., less-developed countries, while in fact the skill premium has risen in many such nations.

One explanation for a rising skill premium in developing countries is that the technology transfer associated with growth of nontraditional exports causes a temporary increase in demand for skilled labor. Even though the exports themselves may be unskilled-labor-intensive in production, skilled labor is needed initially to adapt and implement the imported technologies (Pissarides 1997). Also, the Stolper-Samuelson and factor-price-equalization theorems predict changes in *equilibrium* factor rewards with both factors fully mobile between sectors, and then only under other special conditions. Given the pace of policy change in Latin America since the mid-1980s, the situation can hardly be viewed as such an equilibrium.

Related concerns are the perceived increase in the volatility of earnings and the increased uncertainty of job tenure associated with participation in international markets (Rodrik 1997). These concerns can to some extent be addressed through a social safety net, and indeed Rodrik demonstrates a high correlation between measures of countries' openness and social spending. Furthermore, he points out that increased international mobility of capital implies that such a safety net cannot be financed primarily through taxes on income from capital. However, as long as openness produces

*aggregate* gains to a nation's labor force, social insurance for workers can be financed without increased taxes on capital income.

Sustained high unemployment rates in some Latin American countries reflect slow adjustment to trade and macroeconomic reforms in the presence of labor-market distortions (Burki and Perry 1997). But whatever their cause, increased income inequality and/or volatility can undermine the perceived "fairness" of outward-oriented policies even if accompanied by enhanced growth of per capita income. While countries differ widely in the approaches used to make these changes acceptable to their citizens, the issue must be addressed if integration with international markets is to remain politically viable. During the difficult adjustments of the early 1980s, free-market-oriented Chile protected its poorest citizens with targeted employment and nutrition policies (Graham 1996). In Mexico, social and education programs were used to enhance the welfare of the poor and defuse political opposition to economic reforms in the early 1990s (Cordoba 1994). Even so, unpopular reforms, especially devaluation of the Mexican peso, are credited with helping to end the decades-long political monopoly of the Institutional Revolutionary Party (PRI). Nonetheless, most PRI-initiated trade reforms remained in place.

### Sequencing of reforms

In the developing world (as well as in centrally planned economies), an import-substitution trade regime has typically been one element in a broad complex of dirigiste policies affecting all domestic economic activity--extensive public ownership, selective subsidies, and government restrictions affecting operation of domestic capital and labor markets as well as the foreign exchange market.<sup>22</sup> Furthermore, many developing countries experienced double- or triple-digit inflation rates during the 1960s and 1970s, thanks to over-reliance on money creation to finance government spending. Experience suggests that attention to appropriate sequencing of economic reforms could reduce the period of economic distress following liberalization. A large literature has addressed the issue of sequencing, but without achieving consensus on an optimal sequence that is independent of

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<sup>22</sup> Krueger (1993) points out that the perceived need for these policies may arise from the negative consequences of import substitution--a vicious policy cycle.

the special circumstances of a given country.<sup>23</sup> Moreover, the sequencing literature typically treats trade liberalization as a single element in a broader reform program. Questions less often addressed concern the sequencing of the individual policy changes required to complete a country's successful transformation from import substitution to outward-oriented growth, changes sometimes carried out over a period of years or even decades.

Notwithstanding theorists' concentration on the costliness of restrictions on imports, successful liberalizers most often begin the process of integrating into global markets by restoring incentives for exporters. The initial impetus for import liberalization frequently comes from the needs of current or potential exporters who must look to world markets for capital goods, raw materials, or intermediate inputs. Such measures to facilitate export growth, often enacted in advance of comprehensive reforms, may include rebates of import duties on capital equipment and/or intermediate inputs used to produce exports; establishment of export-processing zones; favorable access to licensed foreign exchange and restricted imports; and other incentives intended to raise the profitability of all or selected export-oriented activities. Subsequent reforms may include broader measures such as elimination of import licensing, tariffication of quantitative import restrictions, rationalization of the tariff structure, and elimination of multiple exchange rates used to discourage "nonessential" imports.

The first step in comprehensive reforms is usually a real devaluation, sometimes along with unification of any multiple exchange rates (Thomas, Nash, et al. 1991). In Chile, Mexico, and Bolivia, an early real devaluation tended to make quantitative import restrictions redundant, thereby facilitating their speedy removal. Although Edwards (1995) notes the increased speed and intensity of trade reform programs in the 1990s, broad tariff reductions were typically implemented in stages over several years according to a schedule announced at the start. At the first stage, the goal is less to spur exports than to move domestic relative prices closer to international prices and to eliminate large discrepancies in domestic effective protection rates.

The Lerner symmetry theorem implies that removing barriers to exports is equivalent to removing barriers to imports. Nonetheless, there may be dynamic advantages in pursuing export

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<sup>23</sup> Edwards (1995) summarizes the main findings of the sequencing debate but comments that sequencing of reforms has come to be viewed as largely a political issue.

promotion prior to general liberalization on the import side. The most controversial aspect of trade liberalization is not the configuration of production and trade in the new equilibrium versus the old one, but the path by which the economy moves from one to the other. In the new outward-oriented equilibrium, both imports and exports will be much larger. However, the extent of overall economic losses and income redistribution, and hence the difficulty of maintaining adequate political support for needed reforms, all depend critically on whether imports grow sooner or later than exports, i.e., whether the current account improves or deteriorates during the period of adjustment. Marked deterioration of the current account signals a likely return to protection (Michaely, Papageorgiou, and Choksi 1991), thus undermining credibility of the reforms. Proceeding first with export promotion (including real devaluation) also creates a set of early supporters of further trade reforms, including both local firms with export potential and foreign direct investors establishing export-oriented subsidiaries.

### The external environment

The case for import-substituting industrialization, as developed by Prebisch, Singer, and other writers, rests in part on export pessimism: the assumption that global markets offer less-developed countries little opportunity for gains through increased exports. Development along lines of international comparative advantage was interpreted narrowly to mean additional export of raw materials and commodities, since these made up about four-fifths of the value of existing exports from less-developed countries as a group. Advocates of import substitution assumed that the international prices obtained for commodity exports would decline over time, exacerbating the gap between rich and poor nations (Edwards 1995). Moreover, their narrow view of outward-oriented growth seemed to offer no role for development of a modern manufacturing sector (Krueger 1997).

Notwithstanding the past successes of export-led industrialization in Latin America and elsewhere, the question of global market receptivity to nontraditional exports continued to lurk in the background during the 1990s, and often with good reason. The World Bank study of trade policy reform in the 1980s identified growing protectionism in international markets as one of several factors constraining exporters' response (Thomas, Nash, et al. 1991). Apparel exports, the first step on the

export-led-industrialization ladder for a host of countries, was also the most protected manufacturing industry in most industrial nations, including the United States.<sup>24</sup> Likewise, agricultural exports from Latin America were limited by quotas, tariffs, antidumping suits, and other restrictions.<sup>25</sup> It is of course true that export-oriented development would work better if rich countries were more willing to adjust out of sectors that have lost their comparative advantage. But, as Sachs and Warner (1995b) conclude, export-oriented development has still worked, even under less than ideal external conditions: “With the...exception of Haiti, there is not a single developing country that had substantially open trade and yet failed to grow by at least 2 percent per year” between 1970 and 1989.

Studies focusing instead on less-developed countries that remained insulated from global markets tell a similar story. From their research into the causes of sub-Saharan Africa’s declining share in world exports, Yeats, Amjadi, Reincke, and Ng (1996) conclude that OECD trade barriers in potential export markets were not to blame: “Rather, the sub-Saharan African countries’ own trade and transport policies incorporate a substantial anti-export bias, which lessens their ability to be competitive in international markets.” If anything, exports from sub-Saharan Africa should have gained an advantage in the markets of industrial nations from trade preferences under the European Union’s Lome Convention as well as the Generalized System of Preferences, but these preferential arrangements were apparently insufficient to offset the anti-export bias of the nations’ own policies.

### Unilateral versus Reciprocal Liberalization

Along with the rest of the world, Latin America experienced a resurgence of regional trade initiatives in the 1990s (see table 7). These included new regional customs unions with negotiated

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<sup>24</sup> The Uruguay Round of multilateral trade negotiations produced an agreement to phase out the Multifibre Agreement (MFA), the global network of quantitative restrictions on trade in textiles and apparel, over a ten-year period. However, many trade policy experts remained pessimistic about a return to open markets for these important developing-country exports. They interpreted the long phase-out period as indicating a lack of real commitment to liberalization on the part of OECD nations. Some analysts believed the extent of OECD protection of these import-competing industries would actually increase, at least temporarily, during the phase-out process.

<sup>25</sup> As discussed below, concern about finding export markets underlies much of the interest in RTAs. Yet even NAFTA failed to prevent Mexican tomato growers from hitting the closed door of restrictive U.S. agricultural policies.

common external tariffs: the revamped Andean Group (1988) and Mercosur (1991). However, most of the new arrangements were free trade areas, including NAFTA (1994) as well as a host of bilateral agreements (Edwards 1995; OAS 1997). Unlike the inward-looking regional agreements of the 1960s, these new agreements were formed as trade of the members was being liberalized on an MFN basis also. Even the language of the agreements was typically outward-oriented, emphasizing enhancement of international competitiveness, export growth, and receptivity toward foreign direct investment. Some observers were unenthusiastic about the regional initiatives, fearing losses from trade diversion, a return to nontransparent protection, rising external trade barriers, and reduced interest in future rounds of multilateral trade negotiations (e.g., Bhagwati and Panagariya 1996). Other researchers, however, argued that regional agreements could help to maintain the region's movement toward openness by enhancing credibility of reforms (e.g., Fernandez 1997).

Given the range of potential benefits from and obstacles to successful liberalization discussed in the previous sections, together with the intellectual climate of general support for market opening in general, what can be said about the choice between unilateral and reciprocal liberalization? Relative advantages may reflect differences in anticipated size of eventual benefits, costs of adjustment, and political feasibility of reform. But in light of the patterns of policy change in the 1980s and 1990s, it may be misleading to cast unilateral and reciprocal liberalization as mutually exclusive alternatives. Rather, they may offer complementary strategies for implementing market-oriented structural reform (McCulloch and Petri 1997), an idea that has been termed "open regionalism" in the Asia-Pacific context.

### Size of benefits

An RTA is likely to cause trade diversion, i.e., substitution of imports from higher-cost partners for goods previously obtained from nonpartners.<sup>26</sup> The cost associated with trade diversion thus reduces potential gains from liberalization with preferential elements; in a free-trade agreement, these

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<sup>26</sup> In a world of many overlapping preferential arrangements, apparent trade diversion may in fact represent redirection of trade flows along lines of comparative advantage, i.e., correction of previous trade diversion. The NAFTA-induced shift of U.S. import orders to Mexico from the Caribbean is an example.

costs may be increased by application of restrictive rules of origin. Nonetheless, unilateral liberalization may produce an inferior final outcome for an individual country that is large enough to influence the terms of trade. If its initial tariffs are below the theoretical “optimum,” a large country’s unilateral liberalization raises world welfare, but the gain comes partly at its own expense. If large countries instead liberalize bilaterally or multilaterally, associated terms-of-trade effects tend to balance out, reducing the possibility that any one country can actually be worse off even after full adjustment. The members of Mercosur and NAFTA include large countries for which negative terms-of-trade effects from liberalization are a significant concern. Grouping with major trading partners neutralizes much of the potential impact.

Also, by promoting action on the part of countries that might otherwise choose to free-ride, reciprocal liberalization may result in *more* liberalization and thus greater global as well as national gains. This is, of course, the logic underlying the multilateral trade negotiations that have helped to reduce many types of barriers to trade in the advanced countries. Essentially the same benefits might be obtained from what could be called “strategic unilateralism,” a scenario in which one country’s unilateral liberalization induces trading partners to follow its example (Coates and Ludema 1996). This kind of leader-follower behavior may be plausible in a repeated-game context. However, the reverse is also possible: some countries may delay trade reform in hope of getting “credit” for their action in a subsequent regional or multilateral negotiation.<sup>27</sup>

Finally, negotiation of regional agreements may be a way to prod other trading partners into mutually beneficial multilateral or regional negotiations. Under United States Trade Representative William Brock, the Reagan administration announced its willingness to negotiate a free-trade agreement with any interested country; Brock’s stated goal was to increase support abroad for initiation of a new GATT round. Chile, supposedly next in line to join an expanded NAFTA, negotiated a free-trade agreement with Mercosur in 1996, perhaps to remind a foot-dragging United

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<sup>27</sup> Uruguay Round negotiators agreed informally to give developing countries credit for earlier unilateral tariff reductions that were subsequently bound under the GATT/WTO. Finger, Reincke, and Castro (1997) find evidence from the pattern of total and bound concessions that developing-country binding of earlier unilateral reductions was “treated at the round as an action of substantial value.”

States of its earlier declarations of interest (Chile's 1991 free-trade agreement with Mexico predated NAFTA).

### Cost of adjustment

Any type of trade liberalization entails adjustment costs that must be measured against the eventual gains from superior efficiency. In the typical case, distorted domestic factor markets exacerbate these costs. The simultaneous opening of several national markets reduces the required extent of dislocation and adjustment for any one of them. An important aspect of this advantage is the reduced need for adjustment of the real exchange rate, an advantage for countries still fighting domestic inflation. Lower cost of adjustment constitutes an economic benefit in itself, but it also reduces the political difficulties of implementing and maintaining the liberalized trade regime. Moreover, in both NAFTA and Mercosur, much of the new regional trade was intra-industry trade (in both cases, autos and parts account for a substantial share of increased trade), presumed by some analysts to be associated with lower adjustment costs than inter-industry trade.

### Political feasibility

An element of reciprocity usually reduces the political obstacles to trade reform. Indeed, greater political feasibility appears to be the most important reason why countries engage in various types of reciprocal rather than unilateral liberalization. In particular, discriminatory liberalization, although almost always suboptimal in at least its initial outcome, offers clear benefits to readily identified domestic sectors in the form of trade diversion, thus ensuring the support of export interests that are known to be regionally but perhaps not globally competitive. In contrast, unilateral liberalization holds out immediate benefits only to the much smaller number of export firms and sectors that appear ex ante to be globally competitive (ex post, the general-equilibrium consequences of a successful liberalization bring to light export potential not apparent in advance). A reciprocal process, whether regional or multilateral, also enhances public acceptance of liberalization. Reciprocity undercuts the public perception that the country's policymakers are giving away something of value (market access) with no quid pro quo.

On the other hand, the negotiations required to achieve reciprocal liberalization may in practice mean a lengthy delay of needed reforms. The decision to liberalize unilaterally seems to occur in conjunction with comprehensive across-the-board reforms. In such instances, liberalization on the part of trading partners would be welcome for the reasons noted above, but the cost of delay is considered too high to make this a condition for the country's own action. In particular, crisis conditions call for prompt action, and so may be associated with unilateral trade reform, as in the case of Chile (1974), Bolivia (1985), and Peru (1990), though cross-reciprocity eased the way for Peru.

### Complementarity

Unilateral, multilateral, and regional initiatives are often discussed as if they were mutually exclusive alternatives. The conventional wisdom is that RTAs induce costly trade diversion and increase political opposition to future reductions in external trade barriers (e.g., Bhagwati and Krueger 1995). Yet Latin American experience in the 1980s and 1990s suggests that these three liberalization strategies may represent complementary ways for a country to move toward greater integration into global markets. During the period, most of the countries in the region reduced their own MFN trade barriers, joined RTAs, *and* participated in GATT/WTO negotiations. Argentina and Brazil were among the last countries to join the region's wave of trade reform, in both cases after previous failed attempts. It is plausible that the Mercosur agreement helped to minimize backsliding despite significant external shocks including the Mexican peso crisis in 1994 and the Asian crisis in 1997. In the first test of the common external tariffs that went into effect in 1995, immediate protests from Mercosur partners forced Brazil to roll back new tariffs and quotas that had been announced unilaterally in response to balance-of-payments problems. While the announced compromise still included new protection directed toward non-members, the episode suggests that speedy pressure from significant partners can help to sustain openness at least within the region if not globally.

The apparent complementarity of unilateral and reciprocal liberalization may reflect scale effects from formation of a larger integrated market as well as changed political and economic circumstances and incentives resulting from the RTA. In a world of constant costs and perfect

competition, trade diversion is necessarily welfare-reducing for the importer. But if non-Vinerian benefits such as increased competition and larger market size are sufficiently important, trade diversion may transform the favored partner into a low-cost producer that is competitive globally as well as regionally. And when non-Vinerian benefits are minor, trade diversion associated with formation of a free-trade area gives each member the incentive to reduce its own external tariffs on product categories where trade diversion is most damaging (Richardson 1993).<sup>28</sup> Moreover, nonmembers who have lost export markets because of trade diversion may be motivated to join later, as occurred in the European Union and ASEAN.

The trade diversion associated with RTAs also provides a way to raise political support for a more-open trade regime. In addition, by promoting a shift in each member's production structure toward sectors that are at least regionally competitive, an RTA can serve as a stepping stone to future nondiscriminatory trade reforms. Of course sectors benefiting from trade diversion will lobby to retain their favored positions. However, these sectors would have opposed multilateral liberalization in any case, while the initially weakest and thus most protection-oriented sectors in each member country have been vanquished through the milder discipline of the RTA and are thus no longer present to oppose further liberalization (McCulloch and Petri 1997). Formation of Mercosur, with its member economies all shaped by decades of import substitution, may help to eliminate the many domestic firms and sectors that cannot prove themselves to be even regionally competitive, thus setting the groundwork for further liberalization in the future.<sup>29</sup>

Finally, participation in international agreements to open markets can raise the viability of reforms by increasing the domestic and international political cost of reversing them. Like

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<sup>28</sup> Trade diversion due to bilateral trade agreements with Mexico (1991), Venezuela (1993), Colombia (1993), Ecuador (1994), and Mercosur (1996) prompted Chile to announce further cuts in its already low unified import tariff.

<sup>29</sup> A controversial study by Yeats (1998) compares Mercosur's internal trade pattern with what would be predicted given only the members' MFN liberalization since 1988 and shows that much of the new intra-Mercosur trade is in industries in which members are not globally competitive. However, this methodology does not distinguish between the traditional categories of trade diversion and trade creation. Moreover, the study compares an actual situation with one that may not have been a feasible option, i.e., sustained unilateral liberalization in countries with a prior record of multiple reversals. As Yeats notes, the study takes no account of credibility of reform strategies or dynamic effects. Also, by comparing Mercosur's intra-bloc trade with members' exports to other markets, the study ignores the potentially important role of import protection elsewhere; this may be significant given that transport equipment and machinery products account for much of the increased intra-trade.

GATT/WTO membership, RTAs therefore lend greater credibility to reforms, especially in countries whose recent history has included numerous liberalization reversals. For Mexico, NAFTA membership was billed explicitly as a way to lock in market-oriented reforms and thus increase their credibility (Tornell and Esquivel 1997). Likewise, establishment of Mercosur helped to bolster the credibility of the latest trade liberalizations in countries with prior records of many policy reversals.

### Promoting Favorable Dynamics with RTAs

The proliferation of RTAs in Latin America, together with the evident enthusiasm on the part of the United States for these arrangements, has raised concerns about their compatibility with further progress toward multilateral liberalization. The key issue is the way RTAs evolve over time and the associated effects on the political viability of future regional or multilateral liberalization. Theory has demonstrated that formation of RTAs can have either positive or negative effects on the success of subsequent multilateral liberalization (Haveman 1996, Levy 1997, Richardson 1993). But in comparison with their theoretical counterparts, real-world RTAs seem decidedly benign in their effects. As indicated above, the evidence for Latin America suggests considerable complementarity between regional and multilateral liberalization. In fact, regional blocs not only appear to facilitate their members' shift from inward-oriented to open trade regimes, but their formation is sometimes explicitly motivated by this goal.

Critics of RTAs worry that these arrangements will be dominated in their effects by costly trade diversion<sup>30</sup> and will cause their members to lose enthusiasm for further multilateral negotiations. Yet

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<sup>30</sup> The traditional literature, following Viner's lead in focusing on the case of constant opportunity cost in production, has probably overemphasized the costliness of trade diversion. As noted above, benefits associated with creation of a larger integrated market can transform a high-cost trading partner into a globally competitive one (Wonnacott 1996; McCulloch and Petri 1997). Moreover, apparent diversion can include welfare-increasing reversal of previous diversion, as in the expansion of U.S. imports from Mexico at the expense of higher-cost goods already afforded preferential access under the Caribbean Basin Initiative.

much of the evidence from actual RTA behavior suggests that policymakers do not typically choose this strategy over participation in multilateral liberalization but, rather, see the two types of liberalization as complementary ways of pursuing gains from integration into international markets. Often the anticipated gains from an RTA are exactly the efficiency-boosting effects of a larger market that theorists find most difficult to capture in a model: scale and scope economies, increased competition, technology transfer.

Nor do members of actual RTAs show signs of systematically exploiting their collective market power by raising their protection toward nonmembers. Nations interact over many issues other than trade, rendering adherence to a blatantly exploitive external trade policy short-sighted. In any case, GATT/WTO rules place limits on the impulse toward higher external barriers. Rather, the increased protection associated with RTAs has typically taken the form of restrictive rules of origin for free-trade areas and discriminatory application of safeguards. These developments are significant worries because they represent a return to the inefficiencies associated with nontransparent barriers, not because the RTA members are optimally exploiting their joint market power in trade with nonmembers.

Theory suggests that an RTA may help to overcome political obstacles to future multilateral liberalization to the extent that trade creation shrinks the size and political power of the region's least competitive firms (McCulloch and Petri 1997). Conversely, trade diversion under an RTA might be expected to strengthen resistance to any future enlargement or multilateral liberalization. In practice, however, it appears that RTAs dominated by trade diversion are ones that never get off the ground because potential members are reluctant to accept the associated losses (e.g., the Andean Pact of the 1960s). The observed tendency for established RTAs to grow in size and diversity over time suggests that membership in an RTA gradually changes the balance of producer interests in ways that promote eventual inclusion of new members who were previously "too competitive" to be allowed to join.

The renewed prominence of RTAs in the 1990s has raised interest in a revision of GATT/WTO rules to increase the likelihood that such arrangements will make positive contributions to multilateral liberalization. One possible approach is suggested by Kemp and Wan's (1976) theoretical demonstration that the external barriers of a bloc can always be adjusted to leave trade with third countries unchanged--i.e., to rule out trade diversion--while allowing net gains for members. Variants of a no-trade-diversion rule have been proposed as alternatives or supplements to Article XXIV of the GATT, which currently restricts RTAs principally through the requirement that countries must fully eliminate internal barriers (Bhagwati 1992, McMillan 1993). However, minimizing diversion does not necessarily produce the most favorable dynamics. Trade diversion may be critical to the political viability of a particular RTA, and if the RTA represents an essential step in the transformation of a country's industrial structure, then a no-trade-diversion constraint may actually retard subsequent multilateral liberalization.

### Conclusions

Beginning in the mid-1980s, greater openness became the norm rather than the exception in Latin America. This increase in openness was confirmed by changes in policies and by changes in trade intensity. Moreover, the increased trade intensity was associated with an increased average rate of growth in the region and in almost all individual countries. In a region where past trade reforms were usually reversed, the key question for policymakers in the 1990s was less *whether* to follow an outward-oriented strategy than *how* to achieve and sustain the required policy environment. The paper identifies political and economic obstacles to trade liberalization in Latin America and looks at ways successful liberalizers were able to overcome them. A central element in sustained progress toward

openness is achievement of macroeconomic stabilization; failed stabilization is usually accompanied by new trade restrictions.

The focus of the paper is on trade reform as an ongoing process, in which implementation of outward-looking policies helps to establish a virtuous cycle of liberalization. In the 1990s, the process unilateral and reciprocal MFN trade reform proceeded in conjunction with negotiation of new regional and bilateral trade agreements. Although they usually imply a sacrifice of efficiency relative to global free trade, such agreements have the potential to overcome domestic political resistance to liberalization and to reduce the costs of adjustment. They may also help to avoid backsliding toward protection by raising the cost of future policy reversals, thus enhancing the credibility of reforms.

Rather than representing a rejection of multilateral liberalization, an RTA may help reshape member economies so as to allow further multilateral liberalization that was not politically feasible previously. Because trade creation under an RTA promotes shrinkage of each member's least-competitive sectors, adjustment to the RTA leaves each country with a larger proportion of firms that are globally as well as regionally competitive and thus raises political support for further liberalization at the multilateral level. At the same time, the renewed popularity and changed emphasis of RTAs suggests that GATT/WTO rules governing regional agreements are due for reassessment. Although losses from trade diversion remain a valid concern, the larger problem to be addressed is the association of RTAs with reversal of progress toward greater transparency of the trade regime.

Table 1.

## Latin American import barriers by country, 1984-93

Country and years	Mean tariff rates, weighted (per cent of import value)			Mean total charges, weighted (per cent of import value)			NTM incidence, weighted (per cent of trade)		
	84-87	88-90	91-93	84-87	88-90	91-93	84-87	88-90	91-93
Argentina (1987, 1990, 1993)	24.8	20.3	9.7	38.6	26.8	16.6	21.2	29.6	3.1
Bolivia (1986, 1988, 1993)	19.5	16.5	9.8	19.5	16.5		32.1	3.5	
Brazil (1986, 1990, 1993)	50.2	28.4	14.7	75.2	28.4	16.9	44.1	22.2	14.3
Chile (1987, 1988, 1992)	19.0	14.3	10.7	20.2	18.3	21.2	16.1	20.7	0.4
Colombia (1986, 1988, 1992)	28.7	25.9	11.7	73.7	43.5	11.7	76.9	80.4	2.3
Costa Rica (1985, 1992)	53.0		15.0						0
Ecuador (1986, 1989, 1993)	29.4	26.7	8.2	39.1	37.4	10.2	51.0	52.2	
Mexico (1987, 1990, 1992)	9.1	8.9	12.3	13.4	9.5	15.8	24.1	22.2	19.0
Paraguay (1984, 1992)	9.2		12.9	63.6		12.9	22.5		4.6
Peru (1984, 1988/9, 1992)	57.0	66.0	17.0					100.0	0
Venezuela (1987, 1989, 1992)	31.4	26.2	14.6	31.4	31.4	16.2	46.1	11.7	2.8

Sources: UNCTAD (1994), except Costa Rica and Peru from Dean, Desai, and Riedel (1994). UNCTAD data weighted by product shares in world trade flows. Tariff data for Costa Rica and Peru weighted by domestic production; NTMs are per cent of tariff lines covered by licensing requirements or quantitative restraints.

Table 2.

Average minimum and maximum tariff rates by selected country, 1984-93

Country and years	Average minimum tariff rates, weighted (per cent of import value)			Average maximum tariff rates, weighted (per cent of import value)		
	84-87	88-90	91-93	84-87	88-90	91-93
Argentina (1987, 1990, 1993)	14.5	17.7	8.2	34.0	21.7	10.3
Bolivia (1986, 1988, 1993)	19.5	16.3	9.5	19.5	16.7	9.9
Brazil (1986, 1990, 1993)	39.3	19.7	9.7	59.1	34.2	18.3
Chile (1987, 1988, 1992)	18.6	14.2	10.5	19.5	14.4	10.9
Colombia (1986, 1988, 1992)	23.1	19.9	9.0	32.6	30.2	14.0
Ecuador (1986, 1989, 1993)	18.6	16.5	6.0	42.0	39.6	10.3
Mexico (1987, 1990, 1992)	4.5	.3.9	9.3	12.7	12.9	14.9
Paraguay (1984, 1992)	7.8		10.0	10.6		15.7
Venezuela (1987, 1989, 1992)	17.6	16.5	10.8	46.4	35.1	18.0

Source: UNCTAD (1994). Sectoral tariff rates weighted by shares in world trade flows.

Table 3.

Exchange rates by selected country, pre-reform and 1995

Country and date of reform	Black-market premium		Real effective exchange rate 1995 (1990 = 100)
	Pre-reform	1995	
Argentina (1989)	40	0	
Bolivia		0	90
Brazil (1987/88)	41	0	
Chile (1985)	16	11	120
Colombia (1985)	9	0	134
Costa Rica (1986)	214	0	101
Ecuador		0	129
Mexico (1985)	15	0	
Paraguay		11	114
Peru (1989)	82	0	
Uruguay		0	157
Venezuela (1989)	103	25	140

Sources: Reform dates and pre-reform black-market premiums, Dean, Desai, and Riedel (1994); official and black-market exchange rates for 1995, World Currency Yearbook, 27th edition (1995); real effective exchange rates for 1995, International Financial Statistics Yearbook (1997).

Table 4.

Income, exports, and growth in Latin America, 1980-95

Country	1995 GDP (billion \$US)	1995 Exports (billion \$US)	1995 GNP per capita		Exports as a share of GDP (%)		Export growth (% per year)		GDP growth (% per year)	
			\$US	PPP est.	1980	1995	1980-90	1990-95	1980-90	1990-95
Argentina	281.1	21.0	8030	8310	5	9	3.7	6.9	-0.3	5.7
Bolivia	6.1	1.1	800	2540	21	20	3.5	6.7	0.0	3.8
Brazil	688.1	46.5	3640	5400	9	7	7.5	7.4	2.7	2.7
Chile	67.3	16.0	4160	9520	23	29	7.0	9.2	4.1	7.3
Colombia	76.1	9.8	1910	6130	16	15	7.5	7.2	2.7	4.6
Costa Rica	9.2	2.6	2310	5850	26	41	6.1	9.5	3.0	5.1
Ecuador	17.9	4.3	1390	4220	25	29	5.4	7.4	2.0	3.4
Mexico	250.0	79.5	3320	6400	11	25	6.6	6.8	1.0	1.1
Paraguay	7.7	0.8	1690	3650	15	36	11.5	13.8	2.5	3.1
Peru	57.4	5.8	2310	3770	22	12	-1.7	8.3	-0.2	5.3
Uruguay	17.8	2.1	5170	6630	15	19	4.3	4.4	0.4	4.0
Venezuela	75.0	18.5	3020	7900	29	27	2.8	4.9	1.1	2.4

Source: World Bank (1997a).

Notes: GDP and GNP per capita are converted to US dollars using a three-year average of exchange rates. PPP estimates of GNP per capita are calculated using purchasing power parities rather than exchange rates as conversion factors. Export and GDP growth rates are calculated using constant-price data. Thus, for a country with deteriorating terms of trade the share of exports in GDP can decline even if export growth exceeds GDP growth over the period.

Table 5.

Initiation of trade liberalization in Latin America  
(liberalizations still in place by 1997)

Country	Sachs-Warner (1995a)	Edwards (1995)	IDB (1996)	Dean et al. (1994)	Type of opening
Chile	1976	Early	1975, 1985s	1985	Unilateral (1970s), cross-reciprocal
Bolivia	1984 (1956-78)	Early	1986s	Not covered	Unilateral
Mexico	1986	Early	1985s	1985	Cross-, intertemporal reciprocal
Costa Rica	1986 (1952-61)	Second phase	1986g	1986	Reciprocal, cross-reciprocal
Paraguay	1989	Third phase	1989g	Not covered	Intertemporal reciprocal
Uruguay	1990	Second phase	1978, 1991s	Not covered	Reciprocal, cross-reciprocal
Argentina	1991	Third phase	1978, 1985, 1989s	1989	Cross-reciprocal (1985), reciprocal
Brazil	1991	Third phase	1990g	1987	Reciprocal, cross-reciprocal
Colombia	1991	Third phase	1991s	1985	Cross-reciprocal
Ecuador	1991 (1950-83)	Non-reformer	1990g	Not covered	Reciprocal; cross-, intertemporal reciprocal
Peru	1991 (1948-67)	Third phase	1990s	1989	Reciprocal, cross-reciprocal
Venezuela	(1950-59) (1989-92)	Third phase	1989s	1989	Cross-reciprocal

Notes: Sachs and Warner (1995a) classify a country as open if nontariff barriers cover less than 40 percent of trade, the average tariff rate is less than 40 percent, the black-market exchange rate of the domestic currency is less than 20 percent below the official rate, and there is no government monopoly on major exports. Dates in parentheses indicate liberalizations satisfying these criteria that were later reversed. Other dates are based on trade policies only. Timing in Edwards (1995) is based on changes in average tariff and nontariff protection, coverage of nontariff barriers, and range of tariff rates. Dean, Desai, and Riedel (1994) and IDB (1996) date liberalizations since 1985. IDB (1996) also distinguishes shock (s) and gradual (g) trade reform. A shock reform cuts average tariffs by at least 50% and removes most NTBs in a two-year period.

Table 6.

Trade taxes as a share of total central government revenue

By country, 1981-90 and 1991-95 (per cent)

Country	1981-90	1991-95
Argentina	13.8	7.9
Bolivia	12.5	6.6
Brazil	2.7	1.9
Chile	8.7	9.6
Colombia	17.0	9.7
Costa Rica	25.5	16.1
Ecuador	20.2	11.6
Mexico	10.1	7.1
Paraguay	14.6	14.8
Peru	20.8	9.8
Uruguay	11.4	5.6
Venezuela	12.6	9.1

Source: World Bank (1997a) Table A.1.

Table 7.

Regional trade arrangements in Latin America  
(arrangements still in effect in 1997)

Arrangement, date, membership	Type of arrangement	Objectives, status in 1997	Comments
Common Market of the Southern Cone (Mercosur), 1991  Argentina, Brazil, Paraguay, Uruguay	Customs union	Establish common market, eventually implement macroeconomic coordination and monetary union. Most internal tariffs eliminated by 1995, remainder to be phased out by 2000. Common external tariffs of 0 to 20 per cent implemented in 1995, exceptions lists to be phased out over 5 years for Argentina, Brazil, and Uruguay, 10 years for Paraguay.	No provisions to facilitate internal labor mobility. Under 1996 agreements to phase out tariffs on trade with Mercosur, Chile and Bolivia became associate members (4+1 formula).
Andean Group, 1969  Bolivia, Colombia, Chile (until 1976), Ecuador, Peru, Venezuela (from 1973)	Customs union	All trade restrictions eliminated on trade between Bolivia, Colombia, Ecuador, and Venezuela; common external tariffs of 5 to 20 per cent (40 per cent for autos) implemented in 1995. Peru's participation lagged, but most trade between Peru and other members liberalized through bilateral agreements.	Early program largely abandoned, group revived beginning in 1989.
Central American Common Market, 1961  Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua	Customs union	Establish economic union, eventually implement macroeconomic coordination and unrestricted movement of capital and labor. Many barriers to internal trade reduced or eliminated; some progress toward establishment of common external tariffs of 5 to 20 per cent, but with many exceptions and reversals.	Group disintegrated during the 1980s, revived in early 1990s. CACM members and Panama established a new organization (Sistema de Integracion Centroamericana) in 1993.
Caribbean Community and Common Market (Caricom), 1973  Antigua and Barbuda, Bahamas (only Community), Barbados, Belize, Dominica, Grenada, Guyana, Jamaica, Montserrat, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Suriname (from 1995), Trinidad and Tobago	Customs union	Economic and political integration. Most members participate in a limited free trade area. Common external tariff established but not uniformly applied by members.	Bilateral agreements with Venezuela (1992) and Colombia (1994) provide for limited period of nonreciprocal preferential access and negotiations on eventual bilateral free trade.

Table 7, continued

Arrangement, date, membership	Type of arrangement	Objectives, status in 1997	Comments
North American Free Trade Agreement (NAFTA), 1992  Canada, United States, Mexico	Free trade agreement	Regional free trade, with eventual extension to a Free Trade Area of the Americas (FTAA). Eliminates most tariffs and nontariff barriers over a ten-year period and liberalizes some service sectors. Includes provisions on intellectual property, government procurement, investment. "Side agreements" on labor, environment, safeguards.	Expansion of Canada-US free trade area created in 1988.
Group of Three, 1994  Colombia, Mexico, Venezuela	Free trade agreement	Total elimination of tariffs over a 10-year period, with some sectoral exceptions; also deals with intellectual property, services, government procurement, investment	Colombia-Venezuela trade remains subject to Andean Group terms.
Bilateral agreements  Chile with Mexico, 1992; Venezuela 1993; Colombia, 1994; Ecuador, 1995  Mexico with Chile, 1992; Bolivia, 1995; Costa Rica, 1995	Free trade agreements	Regional free trade. Agreements include mechanisms for dispute resolution and clear timetables for elimination of almost all trade barriers.	Mexico's agreements similar in structure to NAFTA.
Association for Latin American Integration (ALADI), 1980  Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Mexico, Paraguay, Peru, Uruguay, Venezuela	Regional scope agreement	Increase bilateral trade among member countries and between members and third countries through bilateral and multilateral agreements, with long-term goal of regional free trade; 32 sectoral agreements in place, mostly bilateral.	Successor to Latin American Free Trade Association (LAFTA).

Sources: Edwards (1995), Organization of American States (1997).

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