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Making Trade Liberalization Work

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Since the early 1990s, the Latin American and Caribbean countries have made remarkable progress toward more open foreign trade regimes. Applied tariff rates have fallen sharply, many nontariff barriers have been removed, and multilateral disciplines have become integral parts of national trade policy regimes. In the context of more outward-oriented trade policies, preferential agreements have had a significant impact on trade flows and protection. Although the depth and stability of trade policy reform has differed from country to country, the general trend is indisputable: The region's trade has been significantly liberalized, particularly when compared with initial conditions and with other developing regions of the world.

Overall, trade policy reform led to only slightly faster real export growth (aggregate export volumes increased at a 9 percent annual average rate in the 1990-99 period, as compared with 7 percent in 1980-90 and 6 percent in 1970-80). Aggregate economic performance was also disappointing. Except for Chile, faster export growth failed to translate into rapid expansion of output, productivity, and employment. Output growth accelerated relative to the 1980s, but it was still disappointingly low and below the rates recorded in the developing economies of Asia.

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There is also little evidence of faster growth of total factor productivity or of overall labor productivity. In the aggregate, employment growth was concentrated in the services sector, even in countries whose manufactured exports increased rapidly (e.g., Mexico). In this context, it is not surprising that unemployment, poverty rates, and income inequality did not decrease.

Latin American countries need to sustain rapid export growth to reduce their reliance on foreign savings and lay the foundation for more resilient and faster economic growth. Trade policy reform has helped to reduce the worst inefficiencies of inward orientation, thus raising the growth potential. There is no doubt that a reversal of trade policy would be very costly. But translating faster growth potential into better economic performance requires complementary policies. Past experience shows that the benefits of trade liberalization can be partly counterbalanced by policies that work against sustainable outward orientation. Chile until the mid-1980s and Mexico during the 1990s showed that even strong export growth does not guarantee fast expansion of output.

This chapter assesses the trade policy record and foreign trade performance of Latin American countries during the 1990s, drawing policy recommendations for the future. These recommendations do not constitute a set of ready-made prescriptions. Instead, they aim to draw attention to policy issues that will need to be addressed if trade liberalization is to contribute to better economic performance.

The Consensus on Trade Liberalization and Outward Orientation Before Reform

The aim of trade policy reform in Latin America during the past 15 years has been to abandon inward orientation. The two main ingredients of successful outward-oriented policies are a competitive exchange rate and elimination of the antiexport bias characteristic of import substitution. A competitive and unified (at least for trade transactions) exchange rate is a prerequisite for rapid growth in nontraditional exports. Export expansion needs to be fast enough to "allow the economy to grow at the maximum rate permitted by its supply-side potential, while keeping the current account deficit to a size that can be financed on a sustainable basis" (Williamson 1990, 14). Because there is of course a trade-off between a competitive exchange rate and keeping inflation under control, the use of the exchange rate as a nominal anchor is prudent only when its prospective cost in lower competitiveness is tolerable.

In Latin America, trade liberalization has been frequently accompanied by capital account liberalization. However, the two are conceptually distinct; one can be pursued without the other. Moreover, liberalization of capital outflows is not a main objective, because developing countries should be capital importers and retain their own savings for domestic investment. Indeed, Southern Cone stabilization plans in the late 1970s showed quite dramatically that liberalization of the capital account could result in large capital movements with undesired effects on the real exchange rate.

The first step in eliminating the antiexport bias characteristic of import substitution was to replace quantitative restrictions with tariffs. This would also serve to discourage corruption and to transfer rents from importers to the government. The conventional recommendation was to reduce tariffs over time to a 10 to 20 percent range. Most countries also chose to avoid levying taxes on imported inputs used to produce exports. The general rule was that "the domestic resource cost of generating or saving (one) unit of foreign exchange (should be) equalized between and among export and import-competing industries" (Williamson 1990, 14).

Views varied about the optimal speed of trade liberalization, within a range of 3 to 10 years. The timing of liberalization could even be determined by the state of the balance of payments (as in the European experience of the 1950s) or the economic cycle. These timing recommendations synthesized widespread views about the optimal process of trade liberalization and were shared by many Washington insider analysts and practitioners as well as by Latin American scholars, policymakers, and institutions disenchanted with import-substitution industrialization (ECLAC 1995).

By the early 1990s, there was little dispute about the superior growth record of export promotion as opposed to import substitution. The standard explanation for this contrasting performance was offered by Bhagwati (1987), who argued that export promotion was potentially less distorting than import substitution. Export promotion would help "to get prices right" by, first, preventing antiexport bias and, second, ensuring that budget constraints limit deviations from laissez faire.

However, empirical evidence indicated that the static distortions caused by import substitution were quantitatively too small to account for the strikingly superior growth performance of export promoters. One candidate to account for the difference was better exploitation of scale economies, which were more likely to be accessible under export promotion than under import substitution (Balassa 1982). The combination of outward orientation with industrial and technology policies may encourage greater exploitation of dynamic scale economies in the presence of market failures in technology, international trading information, and financial markets, thus helping to explain the superior growth performance of East Asia vis-à-vis Latin America (Stiglitz 1996).

In sum, since the late 1980s there was widespread agreement that the antiexport bias of Latin America's postwar trade regimes hindered growth and efficiency and distorted the policy process, stimulating rent-seeking practices and corruption. Similarly, there was little dispute over the growth superiority of openness as measured by trade shares in GDP.

However, there was no robust evidence on the channels and policies through which this linkage occurred (Edwards 1993b). The East Asian experience suggested that moving an economy onto an outward-oriented growth path required more than trade liberalization.

Similarly, there was enough evidence that the results of the trade policy reform process would partly depend on whether it was led by import liberalization or export expansion (Agosin and Ffrench-Davis 1993). Despite this broad consensus, however, the predominant policy mood in the region relied too much on straightforward and simplistic policy recommendations that placed excessive emphasis and expectations on a single policy instrument: trade liberalization.

The Extent of Trade Policy Reform

During the past 15 years, trade liberalization in Latin American countries has proceeded through the elimination of nontariff barriers (NTBs), the reduction of applied tariff rates, the enforcement of multilateral disciplines, and the forging of more substantive and encompassing preferential trade agreements (PTAs). These four ingredients combined to produce a significant shift toward more open trade regimes.

NTBs—by far the most distorting device used during the era of import substitution—deprived trade regimes of transparency and created incentives for rent seeking and corruption. In countries such as Argentina, Brazil, and Mexico, nominal tariff rates were largely irrelevant; typically, published rates and the duties that were effectively collected bore little relation to each other, because trade regimes were a compound of ad hoc measures, exemptions, and special treatments. The removal of NTBs during the 1990s was quite remarkable, making Latin American countries on average more moderate users of NTBs than other developing countries (Michalopoulos 1999). Remedial protection became more widespread in the 1990s, but with the possible exception of Mexico, it was less intense than in some industrial countries.

Parallel to the removal of NTBs, applied tariff rates fell markedly. At the turn of the century, Latin America was the most open developing region in the world (as measured by applied average tariff rates) and the one with the highest ratio of bound rates to total tariff lines (table 7.1). According to Laird and Messerlin (2001), by the end of the 1990s, average and maximum tariff rates (as well as other indicators of nominal protection, e.g., the standard deviation and the coefficient of variation of tariff rates) for a sample of six Latin American countries (Argentina, Brazil, Chile, Colombia, the Dominican Republic, and Mexico) compared favorably with a group of East Asian countries (Indonesia, South Korea, Singapore, and Thailand) and European economies that were in transition or developing (Poland, Romania, and Turkey).

Table 7.1 Tariff averages in developing economies, about 1999 (percent)

Region or group	Number of economies	Bound tariff rate[a]	Applied tariff rate[b]	Unbound tariff lines[c]	Coefficient of variation[d]
Latin America and the Caribbean	13[e]	38	13	0	28
East Asia and Pacific	6[f]	30	17	28	155
Sub-Saharan Africa	12[g]	74	20	42	30
Middle East and North Africa	4[h]	47	25	34	40
South Asia	4[i]	64	39	70	33
Higher-middle-income economies	12[j]	35	14	8	82
Lower-middle-income economies	13[k]	42	20	20	32
Low-income economies	14[l]	74	24	54	28
All developing economies	39	51	20	28	50

a. Simple average bound rate at the end of the implementation of the Uruguay Round agreement.
b. Simple average applied rate (latest year available).
c. Share of total tariff schedule.
d. Simple average of country tariff coefficients of variation, where a country tariff coefficient of variation is the standard deviation for applied tariff lines divided by the applied tariff.
e. Latin America and the Caribbean: Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, El Salvador, Mexico, Paraguay, Peru, Uruguay, and Venezuela.
f. East Asia and Pacific: Fiji, Indonesia, Malaysia, Philippines, South Korea, and Thailand.
g. Sub-Saharan Africa: Benin, Cameroon, Côte d'Ivoire, Ghana, Kenya, Mauritius, Nigeria, Senegal, South Africa, Uganda, Zambia, and Zimbabwe.
h. Middle East and North Africa: Egypt, Morocco, Tunisia, and Turkey.
i. South Asia: Bangladesh, India, Pakistan, and Sri Lanka.
j. Higher-middle-income economies: Argentina, Brazil, Chile, Costa Rica, Malaysia, Mauritius, Mexico, South Africa, South Korea, Turkey, Uruguay, and Venezuela.
k. Lower-middle-income economies: Bolivia, Colombia, Dominican Republic, Egypt, El Salvador, Fiji, Morocco, Paraguay, Peru, Philippines, Sri Lanka, Thailand, and Tunisia.
l. Low-income economies: Bangladesh, Benin, Cameroon, Côte d'Ivoire, Ghana, India, Indonesia, Kenya, Nigeria, Pakistan, Senegal, Uganda, Zambia, and Zimbabwe.

Source: Authors' calculations based on Michalopoulos (1999).

The enforcement of multilateral rules also led to more transparent trade regimes and bound countries to implement new disciplines in areas other than trade in goods. Since 1986, 15 Latin American countries have joined the General Agreement on Tariffs and Trade and its successor, the World Trade Organization, including some of the largest economies, such as Mexico and Venezuela. This wave of new accessions occurred at a time when the demands and conditions for membership were being made stricter and more binding. In addition, policymakers frequently used multilateral commitments to lock in unilateral trade reforms. This partly accounts for the fact that Latin American countries display one of the highest ratios of bound to total tariff lines in the developing world (often 100 percent).

Last, more substantive and encompassing PTAs contributed to an increase in the exposure of national economies to foreign competition. The "new regionalism" included more detailed liberalization commitments, a broader exchange of concessions, automatic tariff phase-out calendars, and a relatively high degree of reciprocity (Devlin and Estevadeordal 2001). In addition, many PTAs covered issues other than trade in goods, such as services trade, treatment of foreign investment, protection of intellectual property rights, government procurement, and sanitary measures. A major trait of the new regionalism was the emergence of reciprocal North-South arrangements, such as the North American Free Trade Agreement and the free trade agreement between Mexico and the European Union.

Many Latin American countries continued to use conventional export-promotion instruments (e.g., import-duty drawbacks, export-processing zones, and marketing and insurance support) to offset the antiexport bias of residual protection and to address failures in some key markets (e.g., information and finance). Except for Chile and Mexico, however, these policies did not achieve the expected results (Macario 2000). Since the mid-1980s, Chile has used a series of instruments to promote exports aggressively: "simplified tax rebates," temporary admission of imports, tariff deferrals, exemptions on exporters' capital goods imports, and corrections of informational market failures (Díaz 1995; Agosin 1999; Silva 2001). Mexican policies have deviated significantly from laissez faire as well, as indicated by the extensive use of measures such as the *maquila* regime, generous temporary admission programs (e.g., PITEX), and other incentives (e.g., the ALTEX program and Bancomext export finance; Ten Kate, Macario, and Niels 2000).

Foreign Trade Performance

Trade policy reform was accompanied by faster growth of export values. During the 1990s, Latin American countries' exports rose at a rate double that of the previous decade (table 7.2). However, this was far from an export boom; the region's exports increased at a rate slightly lower than that of all developing countries. Faster Latin American export growth was to a large extent the result of higher sales to the US market and a sharp recovery of intraregional trade flows, in turn stimulated by more substantive PTAs reinforcing unilateral liberalization.

Aggregate figures mask heterogeneous export performances across countries. In fact, the higher growth rate of Latin American countries' exports is largely accounted for by the exceptional performance of Mexico and the Central American economies, whose exports respectively increased

Table 7.2 Performance of export values in Latin America (average annual percent growth rate)

Country and group	1980-2000	1980-90	1980-85	1985-90	1990-2000	1990-95	1995-2000
Mercosur	5	5	4	6	6	10	3
Argentina	6	4	1	8	8	11	5
Brazil	5	5	5	4	6	8	3
Paraguay	9	13	3	24	5	25	–12
Uruguay	4	5	–4	15	3	5	2
Andean Community	3	0	–4	5	7	5	8
Bolivia	1	–1	–8	6	4	5	3
Colombia	6	6	–2	14	7	8	5
Ecuador	4	1	3	–1	6	10	3
Peru	3	–2	–5	2	8	11	5
Venezuela	3	–1	–6	4	6	2	12
LAIA	7	4	2	7	10	11	9
Chile		6	–4	17	8	14	3
Mexico	12	8	8	9	15	14	16
CACM	6	–1	–5	3	13	16	10
Costa Rica	9	3	–1	8	16	21	11
El Salvador	5	–5	–9	–1	16	21	12
Guatemala	4	–2	–7	3	9	12	7
Honduras	4	0	–1	2	9	10	7
Nicaragua	2	–3	–7	2	8	8	8
Total[a]	7	4	1	7	10	11	9
Total (excluding Mexico)	5	3	–1	6	7	9	5

CACM = Central American Common Market
LAIA = Latin American Integration Association
Mercosur = Mercado Común del Sur (Southern Cone Common Market)

a. For 17 Spanish-speaking countries, plus Brazil and Haiti.

Source: Authors' calculations, based on data from the UN Economic Commission for Latin America and the Caribbean.

at 15 and 13 percent average annual rates (well above the 10 percent regional average; see table 7.2). Behind rapid Mexican and Central American export growth is the performance of sales to the US market. Indeed, Mexico was the only Latin American country (except Venezuela, which benefited from higher oil prices) that did not experience a slowdown in the rate of export growth during the second half of the 1990s. If Mexico is excluded, the region's countries saw their export growth in the 1995-2000 period nearly cut in half, from 9 to 5 percent (only slightly higher than the average growth rate recorded in the 1980s).

This poor performance was fully accounted for by adverse price trends; export volume growth increased slightly, from an annual average rate of 9 percent in the 1990-95 period to 10 percent in 1995-2000 (table 7.3). The adverse price performance was a consequence of the fact that Latin Amer-

Table 7.3 Performance of export volumes in Latin America (average annual percent growth rate)

Country and group	1980-99	1980-90	1980-85	1985-90	1990-99	1990-95	1995-2000
Mercosur	6	7	9	4	6	6	6
Argentina	7	7	7	7	7	7	6
Brazil	6	6	10	2	5	5	6
Paraguay	9	13	11	15	5	21	–10
Uruguay	5	5	1	10	5	4	6
Andean Community	5	4	0	8	5	6	4
Bolivia	3	3	–7	13	3	5	3
Colombia	6	7	0	14	5	5	4
Ecuador	6	6	7	6	6	12	0
Peru	5	2	3	1	9	7	10
Venezuela	4	3	–1	8	5	6	4
Chile	9	8	5	12	10	10	10
Mexico	15	15	16	14	14	13	15
Total[a]	8	7	7	8	9	9	10
Total (excluding Mexico)	6	5	5	6	7	7	6

a. For 17 Spanish-speaking countries, plus Brazil and Haiti.

Source: Authors' calculations, based on data from the UN Economic Commission for Latin America and the Caribbean.

ican countries (except Mexico and the Central American Common Market, or CACM) continued to rely on commodity exports, which are characterized by wide price fluctuations. Between 1989 and 1999, the share of manufactures in total exports of the region's countries increased from 30 to 57 percent, largely as a result of structural changes in the commodity composition of Mexican and Central American exports. In 1999, manufactures accounted for 84 percent of total Mexican exports, as compared with just 27 percent one decade earlier. In the case of CACM, the share of manufactures in total exports increased from 39 to 54 percent during the same period.

The contrast in the performance of imports between the 1990s and the previous decade was far more striking than in the case of exports. The average annual growth rate of import values jumped from 1 percent in the 1980s (when imports were repressed by the external debt crisis and international credit rationing) to 12 percent in the 1990s. Again, the highest rate of growth of imports was recorded during the first half of the decade, pushed by import liberalization and, in some countries, a sizable real appreciation of domestic currencies. Mexico emerges again as an exception; in contrast to the rest of the region, the growth of its import values accelerated during the second half of the 1990s (recording a remarkable 18 percent average annual increase, although that was pushed up by the rebound from the crisis of 1994-95).

The rapid expansion of Latin American countries' foreign trade flows during the 1990s led to a significant increase in tradability. Between 1990 and 2000, the ratio of foreign trade (exports plus imports) to GDP rose by more than 50 percent (from 22 to 36 percent). Mexico experienced the largest increase, followed by Brazil and Argentina. However, a much higher proportion of the rise in Mexico's ratio of foreign trade to GDP was accounted for by increased exports than was the case for Brazil and Argentina.

Growth, Employment, and Income Distribution

The performance of growth, employment, and income distribution during the 1990s was disappointing. Trade liberalization in itself was not enough to significantly improve performance, and in some areas (e.g., income distribution) it may have actually contributed to worsening it.

The record of an early reformer, Chile, confirms that strong export growth is not a passport to faster output expansion, because the benefits of trade liberalization can be partly counterbalanced by policies that work against sustainable outward orientation. In fact, during the period of trade liberalization-cum-real exchange rate appreciation of the late 1970s and the crisis that followed, Chile's GDP per capita failed to rise. It was only in the late 1980s that a rising trend in real output was firmly established, partly as a result of the contribution made to outward orientation by other policies, such as preventing a real appreciation of the domestic currency. Total factor productivity increased by 3.9 percent a year during the period 1990-98 (Hoffman 1999).

Mexico is another case of a country that experienced rapid export expansion during the 1990s, but it had a much more modest growth performance (Mexico's previous output peak was overtaken only in 1999). Part of this modest growth can be attributed to the policy of exchange-rate-based stabilization in the early 1990s, which led to a significant currency appreciation until the tequila crisis (Ros 2001). Mexico's trade liberalization-cum-market integration strategy has been successful in many respects, turning the country into one of the major world trading nations and exporters of manufactures.

However, Mexico's rapid export growth has taken place pari passu with deepening dualism. The *maquiladora* regime and the extensive use of temporary admission programs (that benefit around two-thirds of non-*maquila* exports) have reconciled rapid export expansion (from sectors and firms that have access to state-of-the-art technology and inputs at international prices) with a significant presence of backward sectors (Clavijo and Valdivieso 2000). This may account for the failure to achieve rapid productivity growth despite the fast growth of manufacturing exports.[1]

Before 1999, Argentina was usually cited as the country whose economic growth had seen the strongest rebound in parallel to trade liberalization. Between 1990 and 1998, output per head increased at a spectacular 4.4 percent annual rate. However, part of that growth was made possible by the enormous economic slack prevailing at the beginning of the period.[2] Between 1990 and 1998, manufacturing output per hour also increased at a remarkable 7 percent annual rate, but again, a cyclical component accounts for a large share of it. The post-1998 recession and the crisis that led to the collapse of the currency board in early 2002 dramatically worsened Argentina's growth performance, providing a new example of how exchange rate and macroeconomic policies can work at cross-purposes with trade liberalization in the quest for outward orientation.

Employment figures were also disappointing in many countries. In Argentina, in spite of fast economic growth until 1998, unemployment spiraled. Two-thirds of the fall in the number of full-time workers during the decade was accounted for by the loss of manufacturing jobs due to fast growth in output per worker and higher tradability (Frenkel and González Rosada 2000). Employment figures in Brazil performed equally poorly (although Brazil's output growth rates were much lower than those of Argentina).

Moreira and Najberg (1999) studied the employment cost of adjustment during the trade liberalization period in Brazil and found that job destruction was largest in capital-intensive sectors (as should be expected). But they also found labor shedding in labor-intensive and, more surprisingly, natural-resource-intensive sectors. The employment performance in Mexico was much better; while the urban unemployment rate rose from 2.6 percent in 1991 to 6.8 percent after the tequila crisis, it went down afterward to reach 2.2 percent in 2000 (underemployment also diminished significantly). However, despite the rapid increase of manufacturing exports, services made the largest contribution to employment growth.

In most of the countries analyzed, poor employment performance had a negative effect on income distribution. Frenkel and González Rosada (2000) studied the evolution of inequality in Argentina and found that the Gini coefficient for those employed rose from 0.42 in the 1991-94 period to 0.46 in 1998. Unemployment, income distribution, and poverty indicators also performed poorly during the initial stage of trade liberalization in Chile. However, unemployment and poverty (but not income distribution) performed considerably better after the late 1980s. In Mexico, de-

1. Total factor productivity increased by 0.7 percent a year during the period 1990-98 (Hoffman 1999).

2. In 1990, real output per capita was at a 22-year low.

spite better employment performance, income distribution and poverty indicators continued to lag behind (Lustig 2001).

The poor performance with regard to poverty and income distribution, which is related to the disappointing evolution of either employment or the skill premium among workers (and sometimes both), deserves a special comment because of the standard prediction that trade liberalization will result in a combination of higher wages and higher employment for unskilled labor in developing countries. Unfortunately, this is an incorrect generalization for most Latin American countries. The classic studies of Leamer (1984) and Bowen, Leamer, and Sveikauskas (1987) show that the abundant factor in most countries of the region is not unskilled labor but rather some natural resource, and that labor skills in the region rank at an intermediate level on a world scale.

Policy Issues for Trade Liberalization

Latin American countries need to sustain rapid export growth to reduce their reliance on foreign savings and to lay the foundations for faster economic growth. Earning foreign exchange through higher exports and foreign direct investment rather than volatile portfolio capital will make the region more resilient and less vulnerable to foreign shocks. This will ultimately improve economic performance. However, to put the region's countries on a sustainable outward-oriented growth path, more than trade liberalization is needed. Trade liberalization raises the growth potential, but translating that potential into reality demands a complementary set of policies. Moreover, trade liberalization in the region may not necessarily have positive effects on income distribution, which poses the need for policies to make trade liberalization both sustainable and compatible with equity.

The policy recommendations that follow do not constitute a set of ready-made prescriptions. Rather, they point to critical issues that will need to be taken into account in policy design, paying due attention to national circumstances. We have classified these policy issues in three broad categories: macroeconomic and exchange rate policy, market access, and competitiveness.

Some of the recommendations that follow are beyond the discretion of the region's policymakers, such as ensuring adequate market access to third-country markets. Others demand institutional capabilities that may not be readily available, such as fostering competitiveness or dealing with the adjustment costs of trade liberalization. Finally, some may involve significant trade-offs with other policy objectives (e.g., the tension between controlling inflation and securing a competitive real exchange rate). Yet they will need to be addressed as a coherent whole to enable countries to fully reap the benefits of international specialization. No quick fixes will do the job.

Macroeconomic and Exchange Rate Policy

The experience of Latin America in the 1990s shows the critical role of macroeconomic policy and exchange rate management in making trade liberalization sustainable and part of an effective progrowth strategy. Many Latin American countries implemented trade liberalization policies as a part of economic stabilization programs in which the exchange rate was used as a nominal anchor.

Although there is an obvious conflict between exchange-rate-based stabilization and trade liberalization, many governments chose both. This suggests either that the temptation is too strong, or that there is a poor understanding of the long-term trade-offs, or that there is not much of a choice. It appears that there is some sort of political inertia at work: once a government launches an exchange-rate-based stabilization program, it usually takes a crisis to persuade it to change course.

The costs of real appreciation should not be underestimated, particularly in a context of rapid trade liberalization. A successful trade reform program needs to raise two relative prices: the price of exportables relative to importables, and the price of exportables relative to nontradables. Tariff cuts and the removal of nontariff barriers achieved the former, but the latter depends on the evolution of the real exchange rate. This means that if the domestic currency experiences a real appreciation pari passu with trade liberalization (as a result, e.g., of capital account liberalization cum stabilization), one relative price (exportables relative to nontradables) would be shifting in the wrong direction. This would stimulate an inefficient and unsustainable allocation of too many resources to the production of nontradables.

It is hard to disentangle the effects of trade liberalization, currency appreciation, and capital account liberalization—and even of foreign shocks. But the contrasts between the experiences of Argentina and Chile help to draw some useful lessons.

Argentina started its trade liberalization process in the late 1970s in the context of an exchange-rate-based stabilization program that included full capital account liberalization. This policy mix led to a significant real appreciation of the domestic currency, spiraling current account deficits, a threefold increase in the external debt, and eventually a foreign exchange and financial crisis.

The Argentine trade liberalization-cum-currency board implemented in the 1990s showed similar fragility; given structural vulnerability to terms of trade, interest rate, and contagion shocks, after an initial period of strong growth, lack of flexibility led to protracted stagnation and eventually a full-fledged crisis. In the process, new distortions—such as dual foreign exchange markets, targeted tax exemptions, and volatile trade policies—made a comeback, as policymakers sought desperately for something to do the job of the exchange rate. Eventually, both trade liberalization and economic performance suffered.

Chile, as the oldest and most successful case of free-market reform and trade liberalization in Latin America, displays a revealing contrast between the 1973-82 period of trade liberalization-cum-domestic currency real appreciation and the post-1982 phase. The first period ended in a major economic crisis that included a 14 percent contraction of real GDP and a collapse of the financial system (Agosin 1999; Ffrench-Davis, Leiva, and Madrid 1993).

However, Chilean policymakers learned their lessons. After the financial collapse of the early 1980s, the most dramatic departure from earlier policies was the exchange rate. The domestic currency depreciated continuously in real terms during the 1982-88 period by means of a crawling peg combined with occasional discrete jumps. In contrast to the previous phase, the authorities implemented foreign exchange controls that led to the development of an informal foreign exchange market.

During the 1990s, Chile's real exchange rate suffered the pressures of large foreign capital inflows. To discourage short-term inflows and prevent an excessive appreciation of the domestic currency, the authorities enforced tax and reserve requirements on foreign credits and deposits. The central bank also intervened frequently to limit the extent of currency appreciation, and the (crawling) peg was switched from the US dollar to a basket of currencies to further discourage capital inflows.

Nevertheless, by 1997 the Chilean currency had appreciated by 21 percent as compared with 1990. This was partly reversed by capital flight triggered by the East Asian crisis and financial turmoil in the neighboring Mercosur countries. The experience of Chile demonstrates that managing exchange rate policy to secure the right relative prices is a difficult challenge, particularly in a world of volatile global finance. In such circumstances, countries may need to resort to capital controls to achieve the stated goal, preferably to discourage undesired inflows rather than to constrain capital outflows in times of crisis (when they are least likely to be effective) (Eichengreen 1999).

A stable macroeconomic regime requires conditions that are addressed in other chapters of this book. Most relevant are those concerning fiscal policy and, particularly, the growth of public-sector debt. A large public-sector borrowing requirement or rapid debt growth raises the vulnerability to "sudden stops" in capital flows or other (e.g., terms of trade) external shocks. The impact of these shocks is magnified when public- and private-sector debt is denominated in foreign currency.

Experience has shown that these crises can lead to policy reversals or bring progress toward trade liberalization and outward orientation to, at best, a temporary halt. The Argentine crisis of 2001 and 2002 shows the vast negative spillover effects that macroeconomic turmoil can have on trade policy. But sudden stops in foreign finance and terms of trade shocks are long-standing features of Latin America's integration with the world economy. One may wonder why analysts and policymakers tend to forget these lessons at the crest of the wave.

Market Access

During the 1990s, the Latin American countries' drive toward more open trade regimes was not matched by reciprocal liberalization in industrial-country markets. The exception was preferential North-South agreements, such as the North American Free Trade Agreement (NAFTA), which provided better market access to some countries at the expense of negative discrimination against the rest. The record of Mexico during the 1990s clearly demonstrates the potentially significant effects of improved market access on export growth.

Indeed, asymmetrical liberalization may not have been very costly in the past, when Latin American countries' trade regimes were strongly inward oriented. However, in the context of more open trade policies, having adequate access to industrial-country markets has become critically important. North-South PTAs—such as the Free Trade Area of the Americas—may partly compensate for the effects of asymmetrical multilateral liberalization. But for them to do so, a number of conditions will have to be met.

South-South PTAs provide an additional avenue to better exploit the benefits of international specialization and more deeply integrated markets. However, these agreements are vulnerable to external shocks and national institutional fragility. For this reason, a multilayered, mutually reinforcing approach that targets better market access at global and regional levels will offer the best promise for positive results.

Making Doha a True Development Round

Although the Uruguay Round of Multilateral Trade Negotiations carried strong commitments and new disciplines for developing countries, the industrial economies offered modest trade liberalization in areas vital to developing countries' export growth. One possible exception was textiles, but even there transition periods were extremely long and concessions were postponed toward the end of the period.[3] The consequence was that significant trade barriers remained virtually untouched in sectors of

3. Some fear that the elimination of textile quotas by 2005 may be compensated for with more aggressive enforcement of trade remedies.

prime interest for Latin America, challenging the reciprocity principle that should provide the basis for these multilateral negotiations.

Developing countries' exports to industrial markets face tariff peaks and significant tariff escalation. Tariff peaks are frequent for agricultural staple foods, and they actually increased as a result of the "tariffication" of quantitative restrictions. Tariff peaks are also common in cotton and tobacco, fruits and vegetables, processed food products (including fruit juices, canned meat, peanut butter, and sugar confectionery), textiles and clothing (already quantity restrained by the Agreement on Textiles and Clothing), footwear and leather products, and some automotive and transport-sector products (Michalopoulos 1999).

Similarly, although some reduction was agreed on in the Uruguay Round, tariff escalation continues to be a major feature of industrial countries' protection in sectors such as processed foods, clothing, leather, and wood products. The Uruguay Round reduced the incidence of conventional nontariff measures such as quotas, voluntary export restraints, and nonautomatic licenses, but tariff rate quotas are still common in agriculture.

The use of nontraditional trade barriers is more difficult to evaluate, but they have become more important as border protection has waned. Contingent protection has been on the rise and has become more sophisticated, especially targeting developing countries. Moreover, technical and sanitary standards can act as new barriers to trade if concepts such as the precautionary motive or practices such as mandatory labeling are eventually adopted. The multifunctionality of agriculture and the link from market access conditions to environmental and labor standards have also become major causes of concern for developing countries.

One result of the Uruguay Round was to make export and production subsidies subject to stricter disciplines. But these disciplines are not evenhanded; the kind of domestic aids most frequently used by industrial countries (e.g., regional development funds or environmental protection assistance) were left largely untouched. Moreover, agricultural subsidies were made legal and, in spite of the shift toward less price distorting mechanisms, the volume of funds allocated to domestic aids has hardly fallen. Considering where comparative advantages lie, and the severe budget constraints and low per capita income of developing countries, this is a major and legitimate grievance.

The Doha Round must be a true development round if trade policy reform in Latin America is to be sustainable and help the region to fully reap the benefits of specialization. Strong political-economy forces oppose the liberalization of sensitive sectors in industrial countries. These forces will not be counteracted easily. This is why the region should aggressively pursue a strategy of market opening in the Doha Round, supporting initiatives such as the elimination of tariff rate quotas, "peak for peak" tariff negotiations, and a significant reduction of agricultural export and production subsidies (including the closure of loopholes, e.g., the "blue box"). Maintaining negotiations as a "single undertaking" offers the best way to help address the backlog of market access issues that interest the developing world.

Negotiating a Balanced FTAA

One of the novel features of regional integration during the past 15 years has been the emergence of North-South preferential trade agreements in the Western Hemisphere. Given a fixed level of multilateral liberalization, PTAs can be cost-effective as a negotiating strategy, particularly if better market access serves to attract foreign direct investment and stabilize expectations (thus adding to traditional Vinerian considerations; Ethier 1998). These incentives were to a large extent behind Mexico's decision to negotiate NAFTA with the United States and Canada.

It is now well established that NAFTA was a key successful ingredient in Mexico's foreign trade strategy during the 1990s. In effect, NAFTA gained Mexico contractual preferential access into the huge US market (in 1993, the United States accounted for 75 percent of Mexico's total trade in goods). It also helped to stabilize expectations (lessening the risk of future policy reversals) through the enforcement of new disciplines in areas such as foreign investment, services, intellectual property protection, and standards (Lopez-Cordova 2001). The familiar domino effect of trade discrimination (particularly when a large trading partner is involved) led other countries to try to compensate for the negative effects of being left behind. Given the reluctance of the US administration to enter into new bilateral deals, Mexico became—much to its benefit—a hemispheric trade and investment hub.

The ongoing negotiations to create a Free Trade Area of the Americas (FTAA) are an outgrowth of NAFTA. An FTAA will create new opportunities for Latin American countries and become a powerful development tool for the region. It can also become a significant source of economic, political, and strategic benefits for the United States. However, the size of net gains and an even distribution of costs and benefits will require a prospective FTAA to meet certain conditions.

First, the FTAA should be implemented on the basis of reciprocal concessions, taking into account differences in size and levels of development. As was discussed in the previous subsection, reciprocal liberalization among industrial and developing countries made limited progress during the Uruguay Round. Perhaps, by making it possible to focus more clearly on market access gains, preferential negotiations may help to achieve bigger gains than have so far proved possible multilaterally.

However, in areas where there are entrenched domestic interests (e.g., textiles or agriculture) or where policies are deeply intertwined with those of third parties (e.g., agricultural subsidies), substantial progress on a preferential basis will not be easy. Although "defensive considerations" may make nonparticipation too costly and membership almost inevitable (even if these issues are not fully or adequately addressed), this would make an unbalanced agreement and an uneven distribution of costs and benefits more likely. Creative initiatives—such as the adoption of a joint approach and common procedures to combat extraregional agricultural subsidies—could offer a path toward a more balanced deal.

The likelihood of an equitable bargain will be influenced by the dynamics by which the FTAA is negotiated and enforced. Trade discrimination tends to exacerbate the mercantilist bias implicit in trade negotiations. FTAA negotiators must openly face this risk. Given the significant prevailing disparities in the Western Hemisphere in economic size, factor endowments, and levels of development, North-South bilateralism will reduce the likelihood of a balanced deal.

Political-economy considerations suggest that the selection of partners will be influenced by the size of transition and adjustment costs, as well as by the tractability of the bilateral trade agenda. A strategy of "choosing and picking up" partners parallel to the FTAA process (particularly by the United States) will most likely lead to a further unlevel negotiating field. The recently concluded free trade agreement between the United States and Chile and the launching of negotiations between the United States and Central America confirm that the FTAA process will move forward as a bilateral or quasi-bilateral exercise. This does not bode well for the prospect of a balanced agreement that takes into consideration the interests of all parties involved.

To be sustainable, an FTAA should also pay special attention to the issue of transition and adjustment costs. Economic integration among countries with significantly different factor endowments offers the promise of large efficiency gains. However, these benefits will accrue only in the long term, whereas sizable adjustment costs will have to be borne during the transition period. The key role that adjustment assistance played in the passage of Trade Promotion Authority by the US Congress in 2002 confirms that this remains crucial in domestic debates on trade liberalization. Different degrees of economic openness and size mean that the impact of dislocations will be highly asymmetric across countries. Differences in per capita incomes and levels of development imply that the financial resources available to cope with them will also differ greatly. Consequently, if the issue of adjustment and transition costs is not addressed explicitly, other policy alternatives may have to be sought (e.g., sufficiently different calendars for tariff phaseouts).

Latin America will be able to fully reap the benefits of an FTAA only if countries have created the required structural conditions to take advantage of free trade. One of these conditions is a propitious macroeconomic environment. Countries subject to periodic external shocks and volatile capital flows are unlikely to be able to cope with sustained liberalization. Although an FTAA may help to diversify exports and raise foreign direct investment and thus increase the resilience of smaller economies, a healthy macroeconomic environment must go hand in hand with trade liberalization. This means that there must not only be fiscal prudence—which might be encouraged by indicative or mandatory hemispherewide targets—but also the introduction of financial mechanisms geared to cope with unexpected shocks and disturbances.

There is no doubt that NAFTA helped Mexico overcome the tequila crisis, but so did the prompt financial assistance made available by the US government and the international financial institutions. Considering the criticism that the IMF has received in recent years for its handling of developing countries' crises (the last episode of which is Argentina), a regional approach may both be timely and give Latin America a sense of ownership. Over the longer term, this might even include some sort of exchange rate arrangement aimed at limiting exchange rate volatility.

Structural conditions for benefiting from free trade also include the effective capacity of countries to take advantage of the opportunities opened by trade liberalization. The risks of "polarization" between countries and regions trapped in virtuous circles of economic growth and vicious circles of economic decay or stagnation must be addressed.

Thus, the FTAA should explicitly consider initiatives aimed at laying the institutional and structural preconditions to benefit from freer trade, overcoming the reluctance to establish new mechanisms or strengthen existing ones. If NAFTA needed a regional development bank or fund, then the rest of Latin America surely will too. At the FTAA level, a stronger Inter-American Development Bank could do the job, provided that part of its activities are explicitly targeted at smoothing regional disparities (particularly in what concerns the availability of public goods).

Increasing the Effectiveness of Preferential Agreements

South-South preferential trade agreements will remain part of Latin America's foreign trade strategies in the future. If the FTAA fails, the region's countries will continue to trade preferentially with each other under the stimulus of geographic and cultural proximity (Frankel, Stein, and Wei 1997). South-South PTAs can also help to deal with distributional concerns inherent to trade liberalization, exploit gains from intraindustry trade, and raise members' bargaining capacity vis-à-vis third parties.

In effect, under standard assumptions, trade liberalization would lead to a *potential* Pareto improvement. Yet an *actual* Pareto improvement would require transfers that involve a great deal of information and quite sophisticated institutions (including fiscal ones). Because few developing countries appear to have the institutional capacity to cope with the adjustment costs associated with trade reform (especially the private costs incurred by displaced workers), a strategy of preferential liberalization—as opposed to unilateral liberalization—may enable them to pick trade partners and smooth the costs of adjustment over longer periods of time, keeping them at more manageable levels. And because participating countries tend to be more similar in per capita income and relative factor endowment, adjustment costs may be lower.

Similarity in factor endowments also lays the basis for intraindustry trade, creating an incentive to reap benefits from increasing returns. The fact that intraindustry trade has risen significantly in agreements such as Mercosur suggests that the gains from increasing returns in South-South agreements are not negligible (Fanelli, González Rosada, and Keifman 2001). South-South agreements can also contribute to raising a region's bargaining capacity vis-à-vis third parties.

But even if there is an FTAA, some regions or groups of countries may wish to engage in deeper integration agreements, such as a customs union (which will, among other things, eliminate the need for rules of origin on intraregional trade). Yet the challenges of South-South integration remain monumental. Even if intraregional trade flows expand rapidly (as they did within Mercosur between 1991 and 1998) their share in total foreign trade will remain modest, limiting the incentives to coordinate. Limited incentives to coordinate and the lack of a focal point for convergence (most likely to be the case in agreements among developing countries) will hinder the sustainability of South-South trade pacts, for trade liberalization and market integration may be reversed during crises.

Other constraints (e.g., weak domestic institutions) may also conspire against the enforceability of agreements (Bouzas 1999). Mercosur offers a good example both of the potential accomplishments of South-South regional integration and also of the policy challenges posed by low but rising regional interdependence in a context of macroeconomic and exchange rate turmoil (INTAL 2001). Given this fragility, a balanced FTAA could provide an anchor and an umbrella for deeper and more effective South-South regional integration agreements.

Competitiveness

An open trade regime is a necessary condition for an efficient economy. However, in a world characterized by market failures, other complementary policies also are needed to reap the benefits of international specialization and the dynamic gains from trade liberalization. The empirical evidence collected in the literature on both trade and growth shows the existence of large international differences in production functions (Clark and Feenstra 2001; Trefler 1993, 1995; Easterly and Levine 2001), underscoring the fact that technology is not a public good and that the process of acquiring technological capabilities is not automatic.

Moreover, there is evidence that trade and output tend to grow more slowly in countries with rich natural resource endowments than elsewhere (Sachs and Warner 1997; Ros 2001; Sala-i-Martin 1997), a result that seriously challenges Latin American policymakers. Consequently, fostering economic development requires designing a comprehensive strategy to improve competitiveness on the basis of three pillars: (1) building adequate infrastructure, (2) diversifying the productive structure, and (3) developing and strengthening national innovation systems.

A lack of adequate infrastructure is a major factor behind foreign trade repression. Many goods are not traded simply because high transport costs constitute an insurmountable barrier, reducing the set of regional goods and repressing trade. Argentina and Chile, for example, are still connected by only a single paved road, which is occasionally closed in wintertime due to snow storms. Mercosur countries have been largely unable to implement integrated customs facilities because of budget constraints. The high cost of foreign trade services reduces the incentive to spread production across countries, lowering the scope for intraindustry trade. Foreign official assistance could significantly contribute to upgrading trade-related infrastructure by focusing on regional projects or national projects with regional spillovers.

Export policy can help to diversify production. In this regard, an active commercial diplomacy geared to securing market access, identifying new opportunities, and counteracting trade restrictions can help to expand exports. This demands a highly trained foreign trade bureaucracy (a resource in short supply in part of Latin America) able to cooperate with the private sector and supply information on opportunities offered by trade agreements to potential exporters. There is a place for export promotion focused on providing information, supporting marketing abroad, and facilitating access to export finance and insurance.

Many of these instruments are already in use in Latin America, but implementation is frequently poor. Upgrading institutional capabilities to make better use of resources already channeled to these areas is therefore necessary, and successes such as ProChile confirm that this is quite possible. A neglected but valuable idea would be to establish a mechanism to channel venture capital to new exporting firms. World Trade Organization disciplines still leave some (much-reduced) leeway for subsidies, in such forms as regional aids, research and development (R&D) activities, and direct subsidies under a de minimis clause. Export subsidies have been used widely in the past, but with limited success. This suggests that such subsidies as remain should be moderate, temporary, and subject to regular review.

A familiar element of export policy is to allow exporters access to imported inputs at international prices (through temporary admission or duty drawbacks), something already in place in most Latin American countries. One problem with this policy is that it discriminates against domestic suppliers of inputs for exporters. To correct that, such suppliers should also be allowed to recover tariffs and other indirect tax expenses. This would have the merit of reinforcing backward linkages and spreading the benefits of outward orientation. A tax system based on a value-added tax (VAT) that enables export-oriented production to be exempted from the financial burden of "cascading" indirect taxes can also increase the incentive to export, especially if VAT reimbursements are expedited.

Given the pervasive failures that exist in markets for technology, credit, and human capital, policies geared to fostering productivity are the best recipe for improving export performance over the long run. Although the Uruguay Round prohibited nonagricultural export subsidies, it gave a green light to other forms of domestic assistance widely used in industrial countries (e.g., R&D assistance). Three dimensions seem critical to closing the gap in the use of state assistance between Latin American countries and countries that belong to the Organization for Economic Cooperation and Development (OECD) (CEPAL 2002; OECD 1999).

First, forward and backward linkages need to be stimulated, so as to overcome the dualism of dynamic exporting sectors amid a stagnant overall economy and to foster spillovers to the rest of the economy. The provision of public infrastructure and coordination between the government and private firms aimed at strengthening productive clusters might help (CEPAL 2002).

Second, government agencies should assist firms, especially small and medium-sized businesses, on issues of technology diffusion, innovation, and the promotion of human resource development. Government should seek to nurture a strong scientific and technological infrastructure, provide incentives for R&D, and coordinate innovation efforts among universities, research institutes, and business firms. According to the OECD (2001b), the links between technology and science have a strong national component, even for small countries.

Third, because the share of GDP invested in R&D in industrial countries is five times that in Latin American countries, governments should consider offering incentives for private R&D. The public sector should foster links between the university science and technology system, development banks, public and private R&D laboratories, and the business sector.

Conclusions

During the past decade, trade liberalization has proceeded rapidly in most Latin American countries, leading to a significant increase in tradability (as illustrated by the three-fourths rise in the ratio of foreign trade to GDP). Both exports and imports have expanded more quickly, but import growth has by far outpaced the rate of export expansion. This imbalance was made possible by foreign direct investment and portfolio capital inflows, partly stimulated by liquid international capital markets. However, this growth pattern has maintained (indeed increased) the vulnerability of Latin American countries to foreign shocks. Making their countries more resilient is therefore one of the major challenges faced by policymakers. Faster-growing exports and a more diversified export base can make a significant contribution to meeting this challenge.

Although aggregate export performance improved during the 1990s, the record across countries was very heterogeneous. The growth in export values accelerated as compared with the previous decade, but mainly as a result of favorable prices during the first half of the 1990s. During the later years of the decade, export values (excluding Mexico's) increased at a meager 2 percent a year. Export volumes, in contrast, performed roughly in line with the past record.

Exports have remained concentrated in commodities, leaving export earnings vulnerable to wide price fluctuations. Only Mexico and the nations of Central America moved toward a higher share of manufactures in total exports (particularly labor-intensive ones). Intra-Latin American trade diversified toward a higher share of manufactures, but it still accounts for a relatively minor share of total trade. The rise in the share of manufactures in total Mexican and CACM exports was a result of improved (preferential) access to the US market.

Except for Chile, even instances of rapid export expansion failed to translate into high growth of employment, productivity, and output. Although Mexico and Central American countries exhibited a performance superior to the rest of the region (basically due to rapid employment growth in export-processing activities), even their record was far from remarkable. Overall, employment growth was concentrated in services, even in countries (e.g., Mexico) whose manufactured exports increased rapidly. Total factor productivity or overall labor productivity gains have also been limited. Even when measured manufacturing productivity rose, that seems to have been caused by labor shedding, outsourcing, imported inputs, and new labor-saving capital goods. In this context, it should come as no surprise that unemployment rates, poverty incidence, and income inequality did not decrease satisfactorily regionwide.

Trade liberalization made a significant contribution to correcting the grossest inefficiencies of Latin America's past trade regimes. However, lower protection has not been a panacea for better economic performance. The experience of the 1990s indicates that complementary policies are needed. Specifically, countries need better access to international markets, not just lower tariffs on their part; policies to increase competitiveness; and an exchange rate and macroeconomic policy regime consistent with outward orientation.

A Free Trade Area of the Americas could make a decisive contribution to promoting outward orientation in the region—provided it takes the form of a balanced agreement that respects the interests of all its members, helps countries deal with transition and adjustment costs, is enforced in a transparent and balanced manner, and promotes a sustainable macroeconomic environment. These demands pose a big challenge to policymakers in Latin American countries, as well as to the rest of the international community. Although many of the issues outlined will not be easily addressed, an oversimplified policy agenda is no substitute. Insisting on such an inadequate approach would most likely backfire, at the expense of sustainable economic reform and better economic performance.