CICLO DE SEMINARIOS 1996

DEPARTAMENTO DE ECONOMIA

Trade Reform, Economic Integration and Macroeconomic Shocks

Guillermo Mondino

UNIVERSIDAD DE SAN ANDRES
BIBLIOTECA

Universidad de San Andres

Sem.
Eco.
96/28

Universidad de
San Andres

DEPARTAMENTO DE ECONOMIA

Trade Reform, Economic Integration and Macroeconomic Shocks

Guillermo Mondino (IEERAL de Fundación Mediterranea)

Universidad de
SanAndrés

CICLO DE SEMINARIOS 1996
Día: Martes 22 de Octubre
9:00 hs.

Preliminary, Comments Welcome

Very Rough Draft.
Not to be quoted without authors permission.
Comments Welcome

Trade Reform, Economic Integration and Macroeconomic Shocks

Guillermo Mondino and Alejandro Reca
IEERAL de Fundacion Mediterranea
Buenos Aires, Argentina
February 1996

Universidad de San Andrés

Abstract: This essay is concerned with the threat that macroeconomic factors pose to the extension of Free Trade Agreements (FTA). The basic issues that we analyze are the limitations that such agreements impose on the pursuance of other economic objectives such as: Labor or industrial policies, balance of payment adjustment, fiscal needs and macroeconomic stabilization.

We recognize that trade policy is not the appropriate instrument to pursue such objectives but argue that politically motivated governments are very likely to attempt its use. For this reason we worry about what should a reformist government, that wants to further the cause of free trade, do ? After presenting a stylized story of the problem confronting the government we argue that a necessary condition for more ambitious trade integration is to deepen structural reforms. In particular, the reforms should be directed at increasing the economic system's "flexibility."

We conclude the paper with the presentation of a proposal to institutionalize a scheme to provide financial assistance to countries sufering some of these shocks. Our proposed facility would provide short run financing conditional on the maintenance and even deepening of trade liberalization.

Universidad de
SanAndrés

The 1990's wittnesed widespread economic reform in Latin America. A key component in the reform effort was the move towards increased integration to world markets for goods and capital. The opening effort included unilateral trade liberalization and regional integration agreements. The most ambitious initiative towards regional integration is the attempt to create a seamless market from Alaska to Tierra del Fuego or a Western Hemisphere Free Trade Area by early next century.

The reform initiatives are not uniform as they vary from country to country. Some are more inclined towards unilateral trade liberalization, such as Chile. Others have moved partially towards unilateral liberalization but have been more agressive with regional trade integration (Andean Pact, Mercosur, Nafta and so on). Notwithstanding the renewed impetus towards free trade, some restrictions remain in place. More importantly, at least from the perspective of this essay, all efforts have left some degree of flexibility for the conduct of a (partially) independent trade policy, at least during the transition period. Such freedom is usually left with the clear purpose of allowing countries to use trade instruments to smooth out potential adjustment problems. At the same time, this paper will argue that such liberties operate as a barrier to deeper, more ambitious and widespread integration schemes.

QUAERERE VERUM
Universidad de
SanAndrés

During the normal operation of a market economy several shocks take place that force an adjustment. These shocks can have compounded effects during transition to a new set of economic institutions, like free trade. Some of the problems are microeconomic in nature, like the difficulties and pain of inter-sectoral shifts and adjustments to the new equilibrium production structures. Other, are macroeconomic such as the needs to restore fiscal balance and collect fiscal revenues, or the need to count on cyclical stabilization devices and address balance of payments problems to counter relative price changes. Can an economy that faces these daunting threats commit to free trade in a

sustainable fashion as the regional integration agreements require ? Furthermore, aren't further sacrifices of flexibility in trade policy increasingly costly ?

The purpose of this essay is to analyze the potential threat that macroeconomic shocks or instability may pose for the success of regional trade liberalization strategies and, in particular, to the consolidation of regional blocs. The focus of the paper is to consider other policy reforms that might be necessary to undertake to better prepare countries to cope with (macroeconomic) shocks while sticking to trade liberalization (and regional integration) exercises. We will develop a stylized story of the problem a reformist government faces when choosing whether to continue furthering the integration process. The focus will be, basically, the areas of adjustment mentioned above. In each case, we present and elaborate on the preferred policy actions. In all cases we look at recent events in Latin America and relate them to our analytical framework. The paper concludes with a note of caution to policy makers on the issues to watch for and the preferred way to cope with them. Further, we advance a proposal to evaluate the potential role of a regional insurance scheme that could be implemented as a side agreement to the WHFTA.

The rest of the paper is structured in four sections. Section one will present a brief discussion of the concerns that give rise to this paper. Section two will present an overview of the literature on the political economy of trade integration agreements and its connection to the macroeconomic instability problem. In this section we also present, verbally, a more formal presentation of the problem faced by policy makers. Section three then considers in more detail the four types of shocks that may be encountered by countries and their potential impact on trade policy. Finally, section four concludes with our proposal for a regional insurance scheme.

QUAERERE VERUM
Universidad de
SanAndrés

1. The Issues:

Both theory and practical experience suggest that trade policy is a very inefficient macroeconomic device. It does not create jobs as it can only hope to help preserve a given structure of jobs. Neither does it help boost economic activity as aggregate supply is, typically, negatively affected in spite of debatable potential short run increases in demand. That is, not only are tariffs and quotas an ineffective macro-device but they also create severe distortions. On the other hand, import duties are an easily levied tax with two important side effects which are sometimes highly valued by politicians. First, they raise much desired revenues. Second they please some important constituencies.

In spite of the large long run costs associated with protection, most countries will, nevertheless, resort to trade instruments to help contain macroeconomic disturbances when hard pressed. Economic history in Latin America is littered with examples of macro economically induced trade restrictions. The early 1980's Southern Cone stabilization episodes were always accompanied by liberal trade policies and uniformly ended in macroeconomic crises and widespread trade restrictions (with the sole possible exception of Chile where restrictions were less extensively used). The original attempts at reforming trade regimes in Brazil and Argentina in the mid 1980's were seriously reversed when the "heterodox" stabilization packages collapsed in the late 1980's. The International Monetary Fund (1994), in a review of the trade policy content of Fund-supported programs during 1990-93, found that in about a fourth of the program countries, initial trade reforms were partially reversed. In particular, the Fund cites as the rationale for such reversals the need to safeguard temporarily the balance of payments and fiscal revenues as well as the fact that in many

cases they accommodated domestic demands for protection.[1]

Finally, and most recently, in early 1995, Argentina resorted to a unilateral increase in the statistical tax (that is equivalent to a uniform tariff on all imports) from 3 to 10% to beef up government revenues when its fiscal solvency was being threatened by the recession that followed the Mexican crisis induced capital outflows. In late 1994 and early 1995, Brazil resorted to reductions in tariffs for certain goods to shore up its macro inflation stabilization program. When price discipline seemed more at hand, the Brazilian government then moved to levy very high tariffs on certain consumer goods (most notoriously the increase in tariffs from 20 to 70% on imported cars plus the introduction of quotas) to curtail booming consumption expenditures and appease domestic interest groups.[2] In both country cases, the use of trade policy was on non-Mercosur countries. The problem remains, however, that were macroeconomic needs greater macro induced trade policy might have been used even within the region. Furthermore, and perhaps more interestingly, could new trade agreements be threatened by the need to count on as many stabilization tools as possible ?

When a country enters a trade agreement it must, by force, surrender substantial independence for the conduct of trade policy. For instance, approximately 30% of Argentine international trade is currently undertaken with its Mercosur partners. Additionally, Mercosur being a (imperfect) customs union means that international trade policy is agreed upon for a much larger share of products. For this reason, the ability to potentially levy trade taxes is already rather limited. If one were to accumulate current Argentine trade with Mercosur, Chile, Nafta and other Western Hemisphere countries, the share of trade accounted for would be in excess of 50%. Table 1 illustrates that the

---

[1] We would like to thank Gabriel Sanchez for bringing the results of such study to our attention.

[2] Brazil argued in front of the WTO that such measures were geared to contain a potential run on foreign reserves. Nevertheless, it was also openly argued by public officials, that the government had the duty to protect the national industry from the inflow of auto imports.

same phenomenon holds for most Latin American countries. Trade with partners with which an FTA (or some agreement that approximates an FTA) already exists accounts for a large share in all the countries included there. But, more importantly, were one to account for all hemispheric trade the fraction of trade on which independent actions could be undertaken would be less than 50%.

The problem of available targets for trade actions is further complicated by noting that trade taxes had already been decreasing as a revenue generating mechanism. This can be observed in Table 2 where we show that the fraction of tax revenues accounted for by trade restrictions has come down for all countries here considered. The table also illustrates that the average tariff, defined as the ratio of trade taxes to imports, has come down as well. Both observations indicate that countries have already sacrificed the use of this instrument and had to substitute it for other taxes. The argument here is not that this movement is undesirable (quite the contrary). Rather we think that having reduced trade taxes and increased other forms of revenues means that the marginal cost of taxation through the other forms must have increased. For this reason, further integration could be regarded as increasingly costly.

QUAERERE VERUM
Universidad de
SanAndrés

Summarizing, neither will import duties (on extra-regional countries and products) raise much revenue nor will they be very effective in relieving balance of payment or structural adjustment problems. Those (like us) that favor free international trade will typically use the above observation to suggest that reforming governments should seek international commitments. The problem is, however, that under this scenario the policy burden is shifted to other instruments hopefully less distortionary on average, but that have an increasingly large marginal distortion.

The search for alternative macro instruments is not easy. While L.A. countries were liberalizing their trade accounts they were also being restricted in their use of other instruments.

Access to international capital markets is, by no means, perfect for most governments. With the exception of Chile and Colombia, no other countries in the region enjoy investment grade ratings.[3] What this means is that the possibilities for placement of debt in world markets is rather limited. The effective impact of this policy is that budgets must remain balanced (or pretty close to balance) if high inflation is to be avoided. Hence, when needs arise, there is precious little that governments can do to alleviate the tensions that surge in domestic politics.

A related problem stems from the fact that, for many countries in the region and thanks to historical abuses, monetary policy is no longer an available instrument. The countries that tried to impose a sustained difference in monetary policy stance, like Mexico, end up with dramatic consequences. Others, like Peru and Argentina have (almost) altogether given up their control of monetary instruments thanks to strict rules governing money creation. When this is the case (and we would argue that it is more often the rule, at least implicitly, than the exception) the tools available for macroeconomic stabilization are limited.

QUAERERE VERUM
Universidad de
San Andrés

From a different perspective, countries have not only fewer instruments but are also undergoing a vulnerable transition stage. While the reforms can be judged as being highly successful as regional rates of inflation are down one must also bear in mind that the unemployment rates are higher. This result has less to do with traditional Phillips' curve type phenomena than with the structural transformation and intensive sectoral shift activity taking place region-wide. Any government would appear to be more politically vulnerable to negative employment shocks when unemployment is high than otherwise. Similarly, the sectoral shifts phenomena produces record levels

---

[3] Investment grade rating is an important factor for extended capital market access. Many institutional investors face serious legal and self imposed restrictions on purchases of "lower quality" debt instruments.

of capital reallocation which, in practice, results in very high firm destruction and creation. Once again, a negative macroeconomic shock is bound to make a government more vulnerable to demands by the corporate world to defend those firms currently under distress, not to speak of banking systems exposed to such firms.

A related argument would emphasize the sensitivity of expectations to negative events. Latin American countries have had a history of switching between two drastically different regimes. One regime implies a liberal economic order with controlled public finances and international trade. The second typically involves heavily regulated markets, trade restrictions and high inflation. The speed and quality of investment under both regimes is remarkably different as capital is heavily taxed under the second one. For this reason, relatively small shocks can impact on the probability the market assess of the second regime taking place. In fact, if the market is very sensitive to news, this could result in large movements in the cost of capital and hence on the rate of investment and the current account. The problem is important since countries opted for a fairly liberal policy towards international investments (FDI and portfolio) because of the need for capital to improve living standards. Capital holders (both foreign and domestic asset holders) have proven to be very (excessively ?) sensitive to changes in fundamentals.[4] High sensitivity clearly makes macroeconomic management in these countries more complex.

The above discussion helps motivate the problem a policy maker considering integration will face. He has already reduced or given up a substantial degree of policy independence for the sake of creating credibility. Yet, he still faces very large shocks that could build up intense political pressures.

---

[4] There is some evidence that the market for claims on Latin American debt is "excessively" sensitive to changes in fundamentals (John Clark,(1994)). There is also evidence that domestic factors still play a very important ("excessive" relative to the benchmark of perfect integration) role in the pricing of emerging market securities (Bekaert and Harvey (1995)).

Mexico had, in 1995, to cut its current account deficit from almost 8% to about half. Argentina had, in the same period to cut its current account deficit from 3.5% to, once again, about half that size. Both countries endured deep recessions and large increases in unemployment. Both countries were, on the other hand, at relatively similar stages of their transformation process with unemployment, firm bankruptcies and social pressures. Both countries were, as a result, subject to political difficulties.

The demands imposed on policy makers by shocks like those mentioned are great and the availability of instruments limited.[5] In economic terms, the remaining degrees of freedom to conduct a discretionary trade policy (independently of its pure economic desirability) have, from a political point of view, a very large shadow price. In other words, could we expect policy makers to further expand the cause of free trade under such circumstances ? Or, from a normative point of view, what could governments that currently understand the intertemporal benefits of integration do to make sure that a WHFTA succeeds when they are no more ?

2. A Stylized Description of the Macroeconomic Threat to Regional Integration

In this section we present a heuristic description of the technical problems that a reforming government, interested in furthering trade liberalization, will face. As the discussion above should have made clear, the story we will develop has a number of ingredients that have been analyzed, piece-wise, in the literature before. The main components are a politically motivated government, a set of distortionary tax instruments (on trade and income), a government budget constraint and a dynamic incentive problem associated with investment decisions.

[5] Some would argue that the limitations on the number of instruments available forced policy makers to "play by the book" for a change. The argument then goes on to stress that the recessions will prove to be shorter and shallower than otherwise. According to this view., adding more instruments does not necessarily increase welfare. The point clearly depends on policy makers being subject to intertemporal incentive problems or being prone to capture by special interest groups.

QUAERERE VERUM Universidad de SanAndrés

The literature on the political economy of trade is vast and most certainly not new.[6] However, the formalization of the interaction between the incentives governments face and those of particular interest groups is relatively recent. In particular, the literature dealing with FTAs in a political setting is not very extensive. Perhaps the best known example is the work by Grossman and Helpman (1995). Bagwell and Staiger (1995) also present a very interesting extension. In both cases they show that under politically motivated governments (in the sense of attaching extra weight to the producer surplus of some sectors), free trade agreements can help solve terms of trade imposed externalities between trading partners.[7]

Much closer in spirit to our arguments and, we think, to the case of Latin American countries, Maggi and Rodriguez-Clare (1995) show that FTAs can be an important commitment device in the case of time inconsistencies of political origin. The story they present is that of a small country, in the sense that it has no power to affect international prices. They formalize (and derive under what conditions it would hold) the simple idea that governments enter free trade agreements to create a firewall to separate themselves from special interest groups. Their argument can be very intuitively seen with the following example. Suppose that there are only two periods: In the first, firms decide on investment in one of the sectors of the economy and the government on the level of protection (after bargaining with industry and obtaining political contributions). In the second, firms choose production and government and firms bargain again over protection. Furthermore, suppose that in the second period capital is immobile. Given the stock of capital, and the political motivations of the government, in the second period there will be a positive level of protection. In the first period, since

[6] See Staiger R. (1995) for an excellent survey of the classical literature.

[7] Much in the same vein as the original contributions by Harry Johnson where he argued that two countries with international market power would find it optimal to coordinate trade policy to avoid retaliatory tariffs that always end up in decreased welfare.

firms anticipate protection next period, they will overinvest in the "politically active" sector. The result is then, under reasonably mild conditions, a suboptimal one.

The political economy argument above could be further extended to the case that concerns us. Suppose that the current government, being a reformist one, puts less weight than average on political considerations (in the sense of Grossman and Helpman (94)). The probability that the government that follows reverts to the mean is then very high. Taking into account current costs and benefits, the reformist government may then wish to enter an FTA to commit future governments to pursue free trade. In the example presented above, the second period government would want to extract a larger rent out of the private sector. This could only be achieved by raising protection and granting additional rents to the import competing sector. Investors, anticipating the future direction of trade policy could then slow down the speed of transition to the open economy structure of production in spite of the best efforts by the reformist government.[8] Clearly, the level of welfare that would result would be lower than if the government could pre-commit to free trade. It is plausible (as well as theoretically sound) to think that, to solve these problems, a reformist government would attempt an ambitious FTA.

QUAERERE VERUM
Universidad de
SanAndrés

FTAs as commitment devices are however not altogether optimal. They are not because they set up unconditional rules (rules that do not allow policy instruments to vary with the state of the economic system). For instance, most agreements would set tariffs at a zero level and would not allow escape clauses that permit movements in tariffs under certain conditions. FTAs are credible as a commitment device because, presumably, deviating from them brings associated penalties on the

---

[8] They could even further sink capital (which would conceivably now be cheaper) in the import competing sector. In fact, this would be another result over the sub-optimality of transitory reform policies (see Calvo (1987) for suboptimal liberalization and disinflation policies).

government that does so. For instance, were Mexico to deviate from NAFTA, the U.S. economy could potentially levy retaliatory tariffs, or hinder any further access to IMF facilities or block access to World Bank normal credit lines. For these reasons, an average (in the sense of politically motivated) government would fear deviations from the FTA and would stick to it under normal circumstances.

When would an average government deviate from the FTA ? The answer is clearly that when the costs of remaining in the agreement are higher than the government's perceived benefits. The government's perceived benefits are however the key components here. Since the government is politically motivated, it bargains for contributions from the private groups that will receive the rents awarded by protection. There are two sources of inefficiencies here. First, resource allocation will be distorted in equilibrium as a result of a positive (and plausibly high) level of protection. Second, the rents and revenue generated through this process will most likely, not be returned to the private sector in the usually assumed lump-sum, undistortive, fashion. Rather, the rents will be spent according to some, again, politically motivated scheme that will most likely result in sub-optimal outcomes. The political economy distortion then adds to the social welfare losses. Yet, the government does not fully internalize those losses as the last private distortion conveys some benefits to itself rather than a loss.

For this reason, an average government may want to deviate from the FTA sooner rather than later. The reformist government, that puts a higher weight on social welfare, faces an important challenge. It recognizes that the average one will want to abandon, or cheat on, the FTA too early. Abandoning the FTA early entails social welfare losses that are great as not only will there be the tariff induced distortions and "campaign contributions" but also from the punishment inflicted by old

FTA partners. On the other hand, not entering the FTA, would bring associated other time inconsistencies and over-investment costs as we mentioned before. To complicate matters more, the state of the economy does change over time, as we argued in the previous section. Those variations result in changes in the perceived costs and benefits to agreements. The optimal theoretical response is probably an interior solution: FTAs with benevolent escape clauses and positive protection levels. But these are impractical solutions. Real world trade agreements normally involve a limited number of countries, consider all (or at least most) goods and target a zero tariff at a not too distant future. A practical solution, then, appears to be the signing of FTAs with a limited number of countries leaving some room for the use of trade policy on the rest. But, is there something else that a reformist government could do to further the cause of free trade ?

The above paragraphs discussed the "average" government benefits of deviating from the FTA. We now turn to discuss the costs.

As we argued in the previous section, foregoing the use of commercial policy means that the government has to find other instruments to achieve its macroeconomic objectives. In particular, contrary to most of trade theory analysis, governments have to choose between a number of distortionary instruments to finance a level of expenditures that have an effect on agents' incentives too. That is, the levying of trade taxes in the real world is used to achieve a number of objectives which, had they not been available, would have required the use of other distortionary means.[9] Since both forms of taxation are distortionary, a government should attempt to equalize the marginal

---

[9] As a simple refresher, typical trade theory analysis of protection assumes that the taxes are raised for no purpose other than changing relative prices or favor certain consistency with little gain to the political official. It is also almost always assumed that their revenue is returned in lump sum fashion to consumers. The construct is extremely useful as a thought and pedagogical device. But, for real world economic analysis it would require several important changes.

distortions per unit of additional revenue.[10] One should also include in these computations the marginal political benefit derived from using these taxes. Hence, a government acting in an unrestricted fashion would most likely choose a non-zero level of protection.

The argument can be seen graphically in Figure 1. There, we show three upward sloping curves. All three curves are convex on the tax or tariff rate and are drawn for a given level and allocation of capital. The first, and lowest, represents the marginal distortions that arise from levying regular (i.e. income or VAT) taxes. The second and middle curve represents the marginal distortion from trade taxes as appraised by a "politically average" government. That is, this curve nets out from the economic distortion the assessed marginal political benefits from tariffs. The final and highest curve shows the pure marginal economic distortion or the marginal costs of protection to the reformist government.[11]

For a simple graphical presentation, we will assume that the government has to satisfy an exogenously given budget constraint. The constraint is illustrated in Figure 2 as the vertical line. Assuming that the sum of both tax rates equals the level of government expenditure, we are able to determine the optimal level of taxation.[12] Individual taxes are determined at a point where the straight horizontal line intersects one of the trade lines (depending on the type of government) and the line

QUAERERE VERUM
Universidad de
San Andrés

[10] It is important to note that revenues will probably increase at a slower pace than the tax rate, as bigger and bigger incentives for tax elusion appear. Eventually, a Laffer curve develops. For this reason, the proper element to consider in the calculation of the marginal distortion is not the derivative with respect to the tax rate but with respect to the additional unit of revenue obtained.

[11] Notice that we assume that economic distortions are zero at zero tax rates. Hence the regular taxation line and the reformist government will both start at the origin. The line representing the average government starts at negative levels because for very low levels of the tariff rate, the government gets greater marginal political benefits than the economic distortions it generates.

Also, we assume that political benefits are a positive function of the level of protection awards. We assume too that distortions arising from trade duties are higher and grow faster than those from other taxes. Finally, we assume that the average government trade tax line has a slope in between the other two.

[12] Mathematically, what we have in mind is that the budget constraint expressed in units of GNP is equal to $g = t + d$, where g is the level of government expenditure per unit of GNP, t the average tax rate on income taxes and d the average trade duties times the imports (plus exports if duties are also levied on exports) share.

for regular taxation. The location of the line is determined unequivocally at the point where the sum of both tax rates satisfy the budget constraint, or equal the straight line. Given the assumptions imposed here, it is clear that the average government would rather use a larger share of trade taxes than the reformist one (and conversely for regular taxes).

The graphical analysis allows us to discuss, in a bit more structured fashion, the costs that a government facing an FTA might face. Assume that the FTA includes all the relevant trading partners (akin to unilateral liberalization) and also that the tariff rate negotiated is zero. Under such circumstances, the only source of revenue will arise from regular taxes. This is exemplified at the point where the tax line intersects the budget constraint. Clearly, the one period optimality condition (exemplified above by the straight horizontal line) is broken here.[13] Also, the average government will regret the agreement more than the reformist one since he perceived the effective costs of trade levies to be lower. It is for this reason that, as we argued before, the average government will be tempted to abandon the FTA prematurely.

The example FTA considered in our analysis is quite Draconian, but it helps clarify the point. Real life FTAs could be thought, in the above example, as a reduction in the average tariff. The reduction takes place because a number of imports will now come in with zero protection while others will do so at a positive rate. Equivalently, an enlargement of the FTA is akin to a reduction in the number of goods subject to tariffs and hence a lowering of the average tariff.

What elements, besides the punishment from FTA deviation, will influence the timing of the decision to withdraw ? The story told above illustrates several of them. First, the higher the level of

---

[13] We should not jump to the conclusion that in our story the only source of gains from an FTA stems from dynamics and incentives for capital accumulation. There are also gains that arise from the savings on political contributions as argued above. Clearly though, the reformist government does only gain from the dynamic factor.

government expenditure or "budgetary needs" the sooner will abandonment take place. Second, the higher the marginal distortions arising from trade duties, the slower withdrawal will be. Third, the more restrictive or the more encompassing the trade agreements are (the closest average tariffs over all trading partners are brought to zero) the more likely the pull out is. Fourth, lower distortions from regular taxes (or alternatively more effective collection systems) lead to slower withdrawals. Fifth, higher perceived political benefits from trade policy lead to faster exits. Sixth, the higher the level of economic activity and, hence, the higher tax revenues and the lowest the needs for "counter cyclical" expenditures are, the more likely the FTA will last. Seventh, higher economic volatility will result in more "patient" governments. Yet, it can also lead to quicker abandonment of the agreement.[14]

Finally, and while we have not explicitly dealt with the concept in our previous analysis, interest rates do matter. All of the analysis involves an intertemporal evaluation by governments. The reformist one worries about the future actions and about the investment decisions currently under way. The average government worries about intertemporal gains and benefits of staying in the FTA. For all of them, higher interest rates would result in a quicker abandonment of the FTA. In other words, the more complicated it is to get a hold of international financing at low interest rates, the more likely it is that the agreement will be abandoned soon.

In short, the stylized story told in this section, speaks of a government that concerned with the incentives that the next administration will face has to decide whether it wants to continue with the process of regional integration. Several elements enter that decision. A (somewhat) detailed scrutiny of them, like the one we performed here, helps us identify the type of problems that the

---

[14] As in Dixit and Pyndick (93) higher volatility implies that the option value of remaining in the agreement is higher. On the other hand, the higher volatility also implies that the chance that a large shock takes place increases.

policy maker ought to worry about and, most importantly, the nature of the solutions he ought to seek. They all involve further institutional reforms.

3. Economic Policy Problems and Solutions

In this section, we will consider four main categories of real life problems for which governments try to use trade policy. The analysis will draw on our discussion above and will emphasize the need that a reformist government has to solve some of those issues before considering very ambitious integration schemes. The four aspects are: structural adjustment, balance of payment problems, fiscal needs and business cycles.

Structural Adjustment: As mentioned above, most countries that engaged in trade liberalization also pursued a large number of other reforms. The combination of reforms meant that many jobs are destroyed and many others created. The simultaneity of this process may not be perfect and, making matters worse, the geographical or sectoral/skill location of the appearing jobs may not match those being destroyed. For these reasons, one ought to expect that in the transition process there will be large increases in unemployment and the number of firm bankruptcies. Social pressures will, as a result, mount and governments may be tempted to resort to trade or other industrial and labor market policies to ease the pain of transition.

It is well known that trade instruments are not the proper ones to solve labor market problems. In fact, the introduction of tariffs will only change the incentives back and preserve the old structure of jobs. The proper tools for such problems are labor market reforms and social programs.

In the story we told above, the political "cost" of continuing with an open trade policy can

Universidad de SanAndrés

be thought of as an increase in the political benefits a government derives from protection. Such a shift (graphically represented by an outward movement of the trade curve for the "average government") would result in greater incentives to abandon the FTA. A reformist government considering further trade agreements should then evaluate how to make the system less vulnerable to such temptations. Clearly, the higher the current unemployment rate is, the more difficult it will be to forcefully argue for a sustainable FTA. Similarly, the more inflexible the labor market is, the higher the elasticity of unemployment will be to shocks. For these reasons, the pursuance of free trade policies should also be accompanied with policies that help increase the ability to reallocate workers across sectors. Also, efficient bankruptcy codes ought to be designed such that the impact on employment and the speed of capital reallocation is increased.

Many times, trade liberalization strategies have failed to recognize the capital importance of an accompanying set of policies that improve the workings of a market economy. While it is undoubtedly true that the gains from trade reform are independent of the labor and capital market institutions, it is also true that higher factor mobility will reduce the political vulnerability of the government.[15] It is now politically fashionable to argue that trade policies need time to make themselves sustainable. That free trade will develop, over time, interest groups that will eventually support it politically. It is only necessary some luck (in the sense that negative shocks that force the abandonment of the policy do not take place). The argument we are stressing is that such luck can be bought. The price is labor market and bankruptcy code reforms.

An illustrative case is the Chilean experience of the 1980's. After the 1982 debacle with the

[15] An important component in the theoretical argument that we have been pushing is the assumption that the factors of production are somewhat sector specific. Were they able to move across sectors, the political gains for the government would be greatly reduced.

UNIVERSIDAD DE SAN ANDRES
BIBLIOTECA

dramatic GNP contraction that followed (-15% in 1992-93) and peaking unemployment (30% including emergency unemployment programs) and the moderate reversal of trade policy (tariffs reached 35%), the government decided to deepen the structural reforms. Labor market reforms only then took prominence (and were not really completed until 1985). The labor reforms accompanied some other structural adjustments which, altogether, explained a growth rate between 1985 and 1989 of 6.5% per-annum. By 1989, when elections approached nobody seriously doubted the current trade policy. In only a brief period of time, Chile had managed to create a strong political coalition to support free trade.[16]

Balance of Payments Problems: The process of trade liberalization is usually associated with an initial trade deficit. This is typically due to the fact that imports surge faster than exports thanks to relative price changes and to increases in domestic absorption associated to wealth effects. The trade deficit is many times compounded by the simultaneous liberalization of capital accounts that permit large inflows of capital. Balance of payment problems are, however, not just an issue in the initial stages of reform. They can still cause problems in maturing countries since international terms of trade (intra and inter temporal) can suddenly change against the country. In such cases, countries are almost always forced to adjust by cutting domestic absorption which may result in deep domestic recessions. Under such circumstances, governments could resort to trade restricting measures to shore up its balance of payment problems. Simultaneously, import competing industries will find now a more favorable environment to press for increases in protection.

Previous experience in the area has amply shown that trade restricting measures can only

[16] See Laban and Larrain. (1995) for an account of the political/economic transition to a democratic government in 1989.

Universidad de San Andrés

work transitorily and through large contractions in economic activity. Yet, they are still among the first choices of policy makers that are not committed to trade agreements. The mechanics through which trade duties operate, in the aggregate, are more intuitively seen by looking at the current account as the difference between national savings and investments. Tariffs, in such settings, operate as almost any other tax would. They reduce disposable income and hence impact directly on consumption decisions. Alternatively, one could think of the problem as illustrating the need to create a budget surplus to compensate "excessive" private spending. Naturally, an optimal response by an unconstrained government would be to increase not just regular taxes but also trade taxes (the graphical representation of such needs can be seen as an upward shift of the horizontal line).

A politically motivated government that is bound by an FTA may then, for a large enough balance of payment crisis, find it optimal to abandon the commitment. Which then shifts the problem to the reformist government. What can be done to prevent such deviations from happening ?

The answer to the above question is to introduce capital market reforms to allow for "flexible" saving rates. The idea being that when a balance of payment problem develops, interest rates will increase (as obviously foreign capital is now scarce). If consumers have efficient savings instruments at their disposal, then there is an increased probability that the consumption substitution effects will be sizeable. The reforms require the existence of well designed pension systems, liberalized and carefully monitored banking institutions and a deregulated capital market.

A second mechanism is to introduce tax systems that are efficient in the sense of creating low marginal distortions (which will naturally tilt the optimal tax choice towards them) and that have a high marginal revenue (taxes with inelastic elusion responses or elasticities). It would also be nice to develop a consumption tax base such that they induce thriftier behavior.

In the end, no matter how carefully a reformist government plans these reforms, balance of payment crisis will take place if macroeconomic policies are inconsistent. Too often in the past Latin American countries engaged in such actions. The Chilean episode we mentioned above, the Argentine and Uruguayan ones of the early 1980's, the Brazilian and Argentinean ones of the late 1980's were all a reflection of inconsistent monetary, fiscal and exchange rate policies. For this reason, the best possible insurance against a balance of payments crisis is a careful macroeconomic management.

Fiscal Difficulties: From time to time governments face serious pressures on the budget. Domestic catastrophes, large economic shocks, social pressures can all lead to large fiscal needs that concentrate on a particular point in time. Under such circumstances, an unrestricted government would resort to partial increases in the whole structure of taxes. Our theory suggested that the increases in taxes should be negatively associated to the distortion they generate. Since trade taxes are amongst the most distortionary taxes, they should not be seriously affected. On the other hand, as we argued above a politically motivated government may actually resort to them more heavily since they are popular with some important constituencies, they are not very visible and the distortions they generate while big are only felt in full in the longer term. For these reasons, in practice, they are almost always some of the most affected taxes of all.

A reformist government with concerns over the sustainability of the liberal trade regime ought to develop an efficient and flexible tax code to eliminate, as much as possible, the need (and temptation) to resort to trade taxes. The argument here is no different from the one laid out above. The new tax code should have low marginal distortions and should be "easy" to collect.

Business Cycles: A country's evolution is marked by business cycles. Many times these cycles coincide with drops in demand for certain import competing industries which then will seek protection as a mechanism to preserve demand or to gain market share. Governments are likely to respond positively to such advances since trade taxes are easy to implement and will provide government revenues that can now be used to finance expansionary government expenditures.

Unfortunately, there is relatively little that a reformist government can do to smooth out those shocks. Monetary and fiscal policy flexibility is typically seriously compromised in other credibility building mechanisms and hence can not be used. Perhaps the best institutional reforms that can be pursued are to increase the efficiency of the price mechanism to insure that such business cycles are short and "socially" not very costly.

4. Conclusions and a Proposal: an FTA Insurance Scheme

This essay has argued that the liberalization efforts undertaken by many Latin American governments over the last five years have restricted the availability of trade policy. While such restrictions are, most likely, optimal in the sense that they provide policy commitment they also have increased the shadow price of further progress towards integration.

The issues that concern us here are the potential vulnerabilities of current trade initiatives to macroeconomic shocks. We have discussed the way in which a politically motivated government would want to deviate from the agreements when confronted with high unemployment and bankruptcy rates, when facing balance of payment or fiscal crisis and when confronting a deep economic recession. We argued that there were many things, in the form of institutional reforms that could be pursued to ameliorate the incentives and strengthen the liberal trade commitment. Labor

QUAERERE VERUM Universidad de SanAndrés

market reforms, capital market deregulation, liberalization of financial systems and improvements of bank supervision, bankruptcy codes, tax reform, and so on.

Still, there is something else that reforming governments could do. They could work to "complete" the international capital market. Most of the problems we argued about arouse from an incomplete or imperfect international capital market. Balance of payment crisis following capital outflows, difficulties in accessing financing for sudden fiscal needs and so on. Clearly, one of the reasons why the markets do not provide funding under those circumstances stems from an incentive problem. This can be restated as problems arising from great difficulties or very costly monitoring. There are, however, several international financial institutions that carefully follow developments in the region. The World Bank, the IMF and, most importantly, the I-ADB. Those institutions (the last one in particular) should be able to solve those incentive problems.

We propose that, the I-ADB for example, create a new facility directed at the preservation of FTAs. The facility would provide short term financing (as most of the problems we mentioned were truly short term) which would be conditional on the pursuance and maintenance of free trade policies.[17] The facility would not be directed, as the new North American Development Bank is, to solving structural problems but rather high frequency disturbances. We would, in fact, suggest that countries ought to have a zero balance on such an account (most of the time) and would only be allowed to run deficits under well documented and clearly pre-specified circumstances. In other words, financing would have to be canceled in full (both interest and principal) after a brief period of time. The facility we propose could be introduced as a side agreement to the signing of the

[17] Much to our chagrin, it appears that many times the programs that have the support of the IMF and World Bank, are less concerned with trade issues than they are with "balance of payments" or fiscal problems. It is not unusual for a country that has been following reasonably liberal trade policies and that requests assistance from these institutions to get it conditional on a number of objectives. One of them is appropriate tax revenues. This, in Latin American government jargon means higher taxes, trade and the other. See International Monetary Fund (1994).

Universidad de San Andrés

WHFTA.

Economists have, for a long time, thought of free trade agreements as a second best to unilateral liberalizations and as a first step towards a more liberal trade order. Reforming governments, on the other hand, many times view these agreements more as a commitment device to free trade. It is time that economists and international organizations pay more attention to that view. It is important because the region does not have a great history of commitment fulfillment. Those of us that would like to see freer trade should then worry and work to make the new FTAs politically incentive compatible.

Universidad de
SanAndrés

References

Bagwell K. And Staiger R.: "Reciprocal Trade liberalization." Mimeo. October 1995.

Bekaert G. and Harvey C.: "Time Varying World Market Integration." The Journal of Finance. Vol 50 #2, June 1995. Pp. 403-444.

Calvo G.: "On the Costs of Temporary Liberalization/Stabilization Experiments." in Economic Reform and Stabilization in Latin America. M. Connolly and C. Gonzalez-Vega (eds). Praeger Publishers, 1987. Pp. 3-18.

Clark J.: "The Structure, Growth and Recent Performance of the Latin American Bond Market." Federal Reserve Bank of New York. Working Paper #9416. Oct. 1994.

Grossman G. And Helpman E.: "The Politics of Free-Trade Agreements." American Economic Review. Vol 85 #4. Sept. 1995. Pp. 667-690.

Grossman G. And Helpman E.: "Protection for Sale." American Economic Review. Vol 84 #4. Sept. 1994. Pp. 833-50.

International Monetary Fund: "International Trade Policies: the Uruguay Round and Beyond. Volume II. Background Papers." World Economic and Financial Surveys, IMF. 1994.

Laban R. And Larrain F.: "Continuity, Change and the Political Economy of Transition in Chile." In R. Dornbusch and S. Edwards (eds.), Reform, Recovery, and Growth. Latin America and the Middle East. NBER, University of Chicago Press. 1995.pp. 115-148.

Maggi G. And Rodriguez-Clare A.: "The Value of Free Trade Agreements in the Presence of Political Pressures." Mimeo. December 1995.

Staiger R.: "International Rules and Institutions for Trade Policy." In Handbook of International Economics, Vol 3. Grossman G. And Rogoff K. (Eds). North Holland (1995). Pp 1495-1551.

QUAERERE VERUM
Universidad de
SanAndrés

Table 1
Trade Shares with Current FTA Partners and Western Hemisphere
1993

Country	Current FTA Partner	Prospective WHFTA
Argentina	26%	55%
Brazil	13%	47%
Chile	2%	43%
Colombia	14%	64%
Mexico	78%	82%
Peru	9%	57%
Venezuela	6%	78%

Source: International Trade Statistics Yearbook, United Nations.

QUAEREREVERUM
Universidad de
SanAndrés

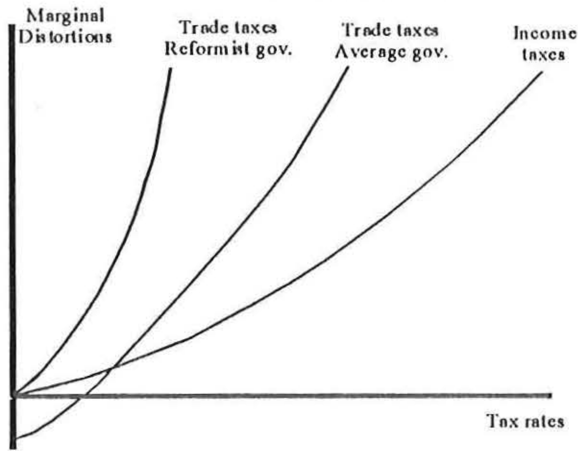
Table 2
Trade Taxes as a Fraction of Total Revenue and Imports

Country	1990	199
Argentina		
Trade Taxes/Total Revenue	21.9	7.6
Trade Taxes/Imports		
Brazil		
Trade Taxes/Total Revenue	8.9	
Trade Taxes/Imports		
Chile		
Trade Taxes/Total Revenue	16.1	8.6
Trade Taxes/Imports		
Colombia		
Trade Taxes/Total Revenue	26.8	12.2
Trade Taxes/Imports		
Mexico		
Trade Taxes/Total Revenue	14.2	12.8
Trade Taxes/Imports		
Peru		
Trade Taxes/Total Revenue	18	9.1
Trade Taxes/Imports		
Venezuela		
Trade Taxes/Total Revenue	7.8	7.8
Trade Taxes/Imports		

Source: World Bank, World Data 1995.

QUAERERE VERUM
Universidad de
SanAndrés

Fig.1
Taxes and Distortions



QUAERERE VERUM
Universidad de
San Andrés

Fig.2
Optimal Taxation and FTAS