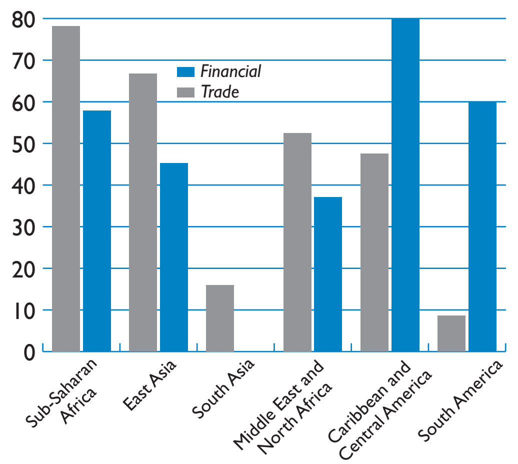
VII External Vulnerabilities

Relatively low trade openness and high financial openness are common characteristics of many Latin American countries. Indeed, Latin America and the Caribbean is the only developing region in which the proportion of countries that are financially open exceeds the proportion that are open to trade (Figure 7.1).

This section explores how the combination of low trade openness and high financial openness—in the context of volatile capital inflows—amplified crisis vulnerabilities in Latin America. The first subsection surveys the considerable range of measures undertaken during the 1990s to liberalize trade and move away from the long-standing strategy of import substitution. The next subsection discusses why, despite these efforts to open the region to trade, Latin America remains relatively closed. The reasons include a number of persistent barriers to trade, the impact of regional trade agreements on outward orientation, and the effects of repeated episodes of macroeconomic instability. The next subsection discusses Latin America's relatively high financial openness and, in particular, the resurgence in capital flows to the region in the 1990s and the continued high volatility of these flows. The channels through which low trade openness and volatile capital flows amplified crisis vulnerabilities are then examined. The final subsection concludes with lessons from the 1990s regarding trade and financial integration, and reviews ongoing efforts and future challenges.

Figure 7.1. Trade and Financial Integration Across Developing Regions, 1975–99[1]
(In percent of open economies)



Sources: Morsink and others (2002); IMF, *World Economic Outlook*, various issues.

[1]For 1975–99, the average share of countries in each region that are open to trade or financial flows. In each year, a country is classified as open if its degree of integration is greater than the median. Trade openness is the sum of exports and imports of goods and services, divided by GDP. Financial openness is the sum of external assets and liabilities of foreign direct investment and portfolio investment, divided by GDP.

Disappointing Outcomes of Trade Liberalization

Efforts to Liberalize Trade

Trade liberalization has been at the heart of the reform process in Latin America, marking a break with the past strategy of import substitution.[138] Over the last fifteen years, many Latin American countries made progress in implementing measures to liberalize trade, although they undertook such efforts at different times.[139] Chile was the first Latin American country to embark on a program of trade liberalization. Its trade reforms were launched in the early 1970s, and by the end of the decade, the economy had become relatively open. Further trade reforms were implemented in Chile during 1983–91. Most other Latin American countries introduced trade liberalization in

[138]Considerable cross-country empirical evidence has shown trade openness is associated with higher productivity and income per capita, and that trade liberalization contributes to growth. Empirical evidence on the positive connection between trade and growth is discussed in Berg and Krueger (2002).

[139]For further details, see, for example, Burki and Perry (1997).

a more abrupt manner. Countries typically implemented trade reform measures over one or two years, beginning in the mid-1980s with Bolivia, Mexico, and Venezuela, followed by Argentina, Brazil, Colombia, and Peru in the late 1980s and early 1990s.

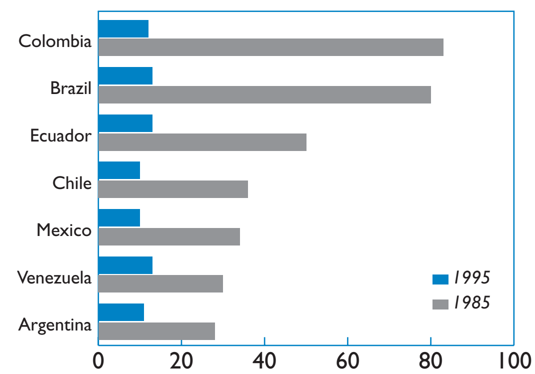
Reducing applied tariff rates was a key component of trade policy reform in Latin America. Tariff rates in Latin America fell from an average of around 49 percent in the mid-1980s to around 11 percent in the late 1990s.[140] Tariff reductions were particularly steep in Brazil and Colombia, where average tariff rates were more than 80 percent in the mid-1980s (Figure 7.2). Tariff dispersion in Latin America also declined from around 30 percent in the mid-1980s to its current level of around 10 percent. From an international perspective, by the end of the 1990s, tariff rates for a sample of six Latin American countries (Argentina, Brazil, Chile, Colombia, the Dominican Republic, and Mexico) were similar to those in East Asian economies and European transition economies.[141]

A number of other policy initiatives also aimed at creating more open trade regimes in Latin America.[142] First, the frequent use of nontariff barriers (NTBs) was scaled back, which improved transparency and eliminated many incentives for rent seeking and corruption. On average, the coverage of NTBs was reduced from nearly 40 percent of imports in the late 1980s to about 6 percent in the 1990s.[143] By the end of the 1990s, the use of NTBs in Latin America was similar to that in Asian emerging market countries.[144] More subtle forms of nontariff measures have emerged, however; and, as discussed later, these are obstacles to promoting greater trade opening.

Second, since the mid-1980s, 15 Latin American countries have joined the General Agreement on Tariffs and Trade (GATT) and its successor, the World Trade Organization (WTO). Adhering to the rules of these multilateral agreements has helped them to create more transparent trade regimes. The Uruguay Round negotiations, which took place during 1986–94, focused on improving market access by reducing obstacles to trade in goods and services and on ensuring that the resulting expanded market access would become legally binding under WTO rules. For Latin America, participating in these negotiations further expanded commitments to reduce import barriers.

Third, the "new regionalism" reflected in broader regional trade agreements contributed to lowering average levels of protection and boosting exports within the region, although their broader impact on development of exports to markets outside of the region has been less positive.[145] Since 1990, more than 30 such initiatives were developed, ranging from free trade areas to customs unions (Table 7.1). Notably, Mercosur, established in 1991, included Argentina, Brazil, Paraguay, and Uruguay in a common market with a common external tariff and trade policy. Overall, these many agreements included commitments to liberalize and introduced a large number of mutual concessions, schedules for tariff phase-outs, and a relatively high degree of reciprocity.[146]

Figure 7.2. Selected Latin American Countries: Average Tariffs
(In percent)



Sources: Lora (2001).

[140]Based on evidence from Lora (2001).

[141]Estimates are from Laird and Messerlin (2003).

[142]Many Latin American countries also used export-promotion schemes (for example, import-duty drawbacks, export-processing zones, and marketing and insurance support) to foster and develop export markets. As discussed in Macario (2002), however, with the exceptions of Chile and Mexico, export promotion was relatively ineffective in boosting export growth.

[143]Estimate based on 11 Latin American countries for which data are available. For further details, see IADB (1996).

[144]Evidence in Burki and Perry (1997) shows that the weighted incidence of nontariff measures in Latin America fell from more than 30 percent in the 1980s to around 5 percent in the early 1990s, which was just above the level in the Asian newly industrializing countries. Nontariff restrictions are measured as the weighted percentage of tariff-code lines covered by various types of nontariff barriers (such as licenses, quotas, and prohibitions) as a percentage of all tariff code lines, using as weights the countries' respective shares in world trade.

[145]For a detailed examination of regional trade agreements in Latin America, see IADB and Iglesias (2002).

[146]See for example, Devlin and Estevadeordal (2002). The objectives of the "new regionalism" go well beyond reducing trade protection. Other equally important objectives of these arrangements include supporting structural economic reforms; providing new opportunities for exports and diversification, which can serve as stepping stones to improved global competitiveness; attracting foreign direct investment; and fostering regional cooperation. For a detailed discussion, see IADB and Iglesias (2002).

Table 7.1. Latin America: Regional Integration Initiatives, 1990–Present

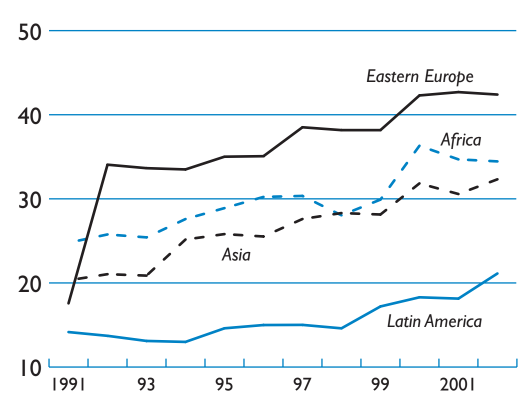
Completed Agreements (Year Signed)	Negotiations in Progress
Intraregional Agreements	**Intraregional Agreements**
Southern Cone Common Market-Mercosur (1991)	Mercosur-Andean Community
Chile-Venezuela (1993)	Costa Rica-Panama
Colombia-Chile (1994)	Mexico-Panama
Costa Rica-Mexico (1994)	Mexico-Peru
Group of Three (1994)	Mexico-Ecuador
Bolivia-Mexico (1994)	Mexico-Trinidad and Tobago
Chile-Mercosur (1996)	
Bolivia-Mercosur 1996)	**North-South Agreements**
Mexico-Nicaragua (1997)	Free Trade Area of the Americas (FTAA)
Central American Common Market-Dominican Republic (1998)	Mercosur-European Union
Chile-Peru (1998)	Chile-European Free Trade Association
Chile-Central American Common Market (1999)	Caribbean Community-European Union
Chile-Mexico (1999)	Central America–4-Canada
Mexico-Northern Triangle of Central America (2000)	Central American Common Market-United States
Caribbean Community-Dominican Republic (2000)	Uruguay-United States
Costa Rica-Trinidad and Tobago (2002)	Mexico-Japan
El Salvador-Panama (2002)	Chile-Republic of Korea
North-South Agreements	**Others**
Mexico-North American Free Trade Agreement (1992)	Brazil-China
Chile-Canada (1996)	Brazil-Russia
Mexico-European Union (1999)	
Mexico-European Free Trade Association (2000)	
Mexico-Israel (2000)	
Costa Rica-Canada (2001)	
Chile-European Union (2002)	
Chile-United States (2003)	

Source: Inter-American Development Bank and Iglesias (2002).

Disappointing Results

With these considerable efforts to liberalize trade, some progress was made in diversifying countries' exports and raising the shares of trade in their GDPs. Overall, however, integration with the global economy has proceeded very slowly. Latin American economies remain much less open than those in the rest of the world. Latin American exports as a share of GDP rose from around 15 percent at the start of the 1990s to 21 percent a decade later, but this ratio remains well below those of other developing countries (Figure 7.3).[147] In part, persistent limited trade openness reflects the closed character of Latin America's economies prior to the reforms. Moreover, export growth in Latin America following the reforms has consistently lagged that in the Asian emerging market countries. For example, although export volume growth in Latin America nearly doubled to about 7 percent during the 1990s relative to

Figure 7.3. International Comparison: Exports of Goods and Services
(In percent of GDP)



Source: IMF, *World Economic Outlook*, various issues.

[147]Figures for emerging Asia exclude Hong Kong SAR and Singapore, where exports considerably exceed 100 percent of GDP.

Table 7.2. International Comparison: Export Performance in Latin America and Asia[1]

	Export Volume (Annual percent change)		U.S. Dollar Export Value (Annual percent change)		Exports (In percent of GDP)	
	1980–90	1990–2000	1980–90	1990–2000	1980–90	1990–2000
Argentina	5.04	6.38	2.84	7.52	8.96	9.05
Brazil	5.59	7.34	4.73	6.41	10.10	9.04
Chile	6.09	9.34	5.43	8.01	27.23	29.54
Colombia	7.37	3.68	5.03	6.08	15.07	17.00
Mexico	7.67	11.36	8.22	9.98	16.96	25.20
Peru	–7.74	8.05	–1.57	7.65	16.74	13.38
Venezuela	2.33	2.41	–0.72	6.28	27.49	27.75
Latin American average[2]	3.76	6.94	3.42	7.42	17.51	18.71
Hong Kong SAR[3]	13.11	9.22	14.65	9.27	110.70	139.86
Indonesia	1.15	10.44	3.35	8.87	25.06	31.68
Korea, Republic of	10.87	15.76	13.97	10.86	41.56	34.18
Malaysia	9.65	9.79	8.83	13.10	59.32	96.21
Philippines	3.57	9.25	5.03	13.72	24.17	40.96
Singapore[3]	9.44	11.00	10.77	10.30	179.55	172.00
Thailand	12.39	10.95	14.73	9.93	26.61	46.25
Emerging Asia average[2]	8.60	10.87	10.19	10.74	66.71	79.90
Excluding Hong Kong SAR and Singapore	7.53	11.24	9.18	11.30	35.34	49.86

Source: Catão (2002).
[1]Exports of goods and nonfactor services.
[2]Unweighted averages.
[3]Exports including re-exports.

the 1980s, it remained lower than in emerging Asia (Table 7.2).

This general picture of lagging trade openness in Latin America masks underlying differences across the region with respect to the openness and diversity of trade structures (Figures 7.4 and 7.5).[148] Although Paraguay and Chile have trade shares greater than 60 percent of GDP, most countries in the region are classified as relatively closed to trade. Some countries—such as Colombia—have relatively diverse export structures, while others—such as Ecuador and Venezuela—have highly concentrated export structures with exports in a few primary commodities, such as oil and metals, accounting for a relatively high share of overall exports (Figure 7.6). Nonetheless, it is evident that during the 1990s, countries made progress in diversifying their export structures—for example, Mexico and a number of Central American countries have increased manufactured goods' share of total trade.

Latin America's persistently low and lagging trade openness is another factor explaining its low growth performance over a long period. There is abundant empirical evidence that the more open an economy is to trade with the outside world, the better is its growth performance relative to others. For example, a recent study, Warcziarg and Welch (2003), of 133 countries between 1950 and 1988 demonstrated that countries that liberalized their trade regimes enjoyed higher annual growth rates after liberalization.[149]

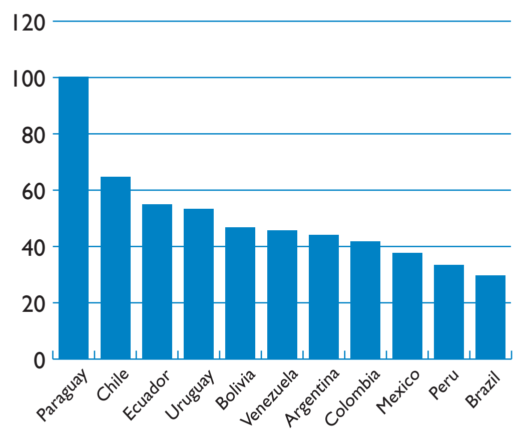
Explaining Disappointing Results

Why did the trade-liberalization efforts of the 1990s not deliver more open economies in Latin America? Geographical location, the size of the economy, the level of economic development, and other influences outside the direct control of policymakers explain why Latin American countries remain relatively closed. Yet, even correcting for these determinants of trade in the context of a gravity

[148]Relatively open economies are typically defined as those that have a total trade-to-GDP ratio of greater than 50 percent. The concentration of exports in product categories is measured by a Herfindahl index of concentration of export shares. An index above 0.28 is consistent with a concentration of 50 percent or more of exports in one of 10 product categories.

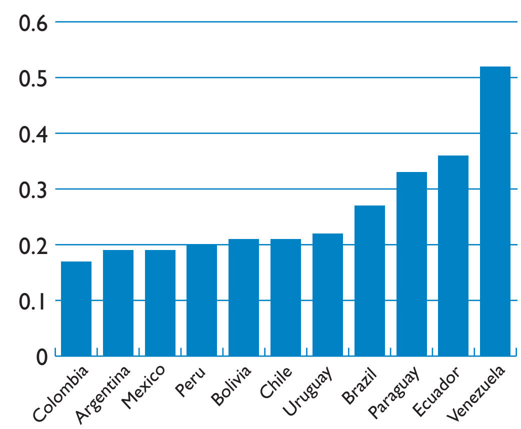
[149]Warcziarg and Welch (2003). See also Krueger (2004).

Figure 7.4. Selected Latin American Countries: Trade Openness, 2002[1]
(In percent of GDP)



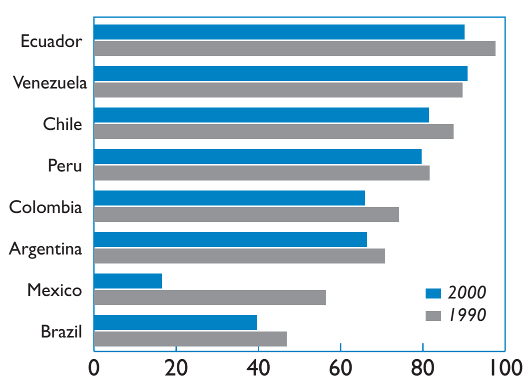
Source: IMF, *World Economic Outlook*, various issues.
[1]Trade openness is measured as the sum of exports and imports of goods and services.

Figure 7.5. Selected Latin American Countries: Herfindahl Index for Exports[1]
(Index, 0 to 1)



Source: IMF, Trade Policy Information database.
[1]Herfindahl Index measures the concentration of export shares. A lower value of the index indicates a more diverse export structure. Data are for 2001.

Figure 7.6. Selected Latin American Countries: Commodity Exports
(In percent of total merchandise exports)



Source: World Bank, *World Economic Indicators*, various Issues.

model, Latin American countries tend to trade less, on average, than would be expected.[150]

A broad range of factors, which are further explained later in this section, explain why Latin America remains relatively closed. These include the considerable scope that remains to lower protective barriers, disappointing results from regional trade arrangements, persistent barriers to trade in industrial countries, the lack of effective trade institutions, and the region's persistently volatile macroeconomic environment.

Further Room to Lower Protective Barriers

Although Latin America's average tariff rates declined dramatically over the 1990s, there is still room to lower tariffs and the level of effective protection. First, a high degree of tariff escalation persists in the region. Tariff escalation describes instances where more protection is given to higher-value-added products than to raw materials or less-processed inputs. Thus, even though tariff rates overall have been reduced, the prevalence of tariff escalation means that effective protection of manufactured goods remains high.[151] Over time, such tar-

[150]Evidence on undertrading in Latin America is based on conventional gravity model estimates, and is discussed in Morsink, Helbling, and Sgherri (2002). Such quantitative evidence may overstate undertrading owing to illegal and unreported trade activity.

[151]One prominent example of tariff escalation is the tariff schedule for Mercosur, which affects the trade of some of the

iff escalation discourages higher-value-added exports, leading to a concentration on agricultural goods and raw materials—products that have been hurt by negative terms of trade shocks, high levels of protection in importing countries, and slow growth of world demand. This export structure also tends to insulate these economies from the investment and technology transfers that often accompany trade in more sophisticated manufactured goods.

Second, despite the progress made, nontariff barriers in the form of licensing requirements, government monopolies, quotas or import bans, and trade-related investment measures remain a hindrance to trade. Moreover, countries increasingly are resorting to alternative forms of protection, such as initiating antidumping investigations or invoking the use of technical standards. These more subtle forms of protection are particularly difficult to quantify and could undermine the positive benefits of the trade liberalization that has taken place. Estimates in Inter-American Development Bank (IADB and Iglesias, 2002) suggest that the use of nontariff measures is the highest in Argentina, Colombia, and Mexico.[152]

Third, considerable scope remains to liberalize trade in essential infrastructure services, such as communications, transportation, and finance, which are important inputs into production and trade. Estimates of barriers to trade in business services indicate that liberalization would significantly reduce the cost of production and exports. For example, Stern (2000) cites studies that find a tariff equivalent on business services of more than 30 percent in Brazil, and similar price differentials for telecommunications and financial services in other Latin American countries. Since most business-service exports are delivered through the establishment of foreign firms in the export market, liberalizing trade in services implies a significant liberalization in the rules that affect foreign direct investment.

Regional Trade Arrangements[153]

Although regional trade arrangements in Latin America boosted intraregional trade, they did not vigorously promote export growth outside of the region. The boost to exports from regional agreements was concentrated among major trading partners in South America including Mercosur (Argentina, Brazil, Paraguay, and Uruguay) and the Andean Community (Bolivia, Colombia, Ecuador, Peru, and Venezuela).[154] Indeed, intraregional trade for the Mercosur countries increased from about 7 percent of total trade in 1992 to around 20 percent in the late 1990s, and for the Andean Community from about 8 percent to 11 percent during the same period. These principal agreements were designed as common markets (which require members to have common external tariffs), however, rather than free-trade areas (where each member has flexibility to choose its policy toward nonmembers). When the common external tariff is relatively high, these arrangements can result in costly trade and investment diversion.

The effect of establishing customs unions on members' incentives for multilateral liberalization and on the barriers faced by outsiders seeking market access is the subject of ongoing research and policy debate. Evidence with regard to Mercosur—the largest of the region's customs unions—suggests that its efforts to stimulate economic growth among its members have fallen short. The dismantling of internal trade barriers may have increased trade among members of Mercosur. The imposition of common external tariffs may, however, have lowered welfare overall as members shifted imports away from competitive extraregional suppliers toward suppliers that benefited from the agreement.[155] In addition, there is evidence that Mercosur may have led to specialization in products that were not competitive in international markets, which acted to reduce the dynamism of extraregional exports.[156]

To maximize the benefits of regional trade agreements, a number of issues need to be addressed. First, there are particular benefits from trade integration with advanced economies, including increased investment flows and technology transfers. Moreover, benefits to developing countries also arise from integration with an industrial-country partner with more demanding regulatory standards. In the case of the North American Free Trade Agreement (NAFTA), Mexico has benefited from integration with Canada and the United States in many areas, including investment and competition policies,

largest countries in the region. Region-wide studies suggest that there is significant tariff escalation in important product chains, including processed food, textiles and clothing, tobacco, wood products, and automobiles. See, for example, Laird, Cernat, and Turrini (2002).

152IADB and Iglesias (2002) estimates are based on data compiled by the United Nations Conference on Trade and Development (UNCTAD) and the IADB under the project TRAINS for the Americas. Estimates include both quantitative restrictions and technical standards, with the latter being particularly difficult to measure.

153For an overview on the debate about preferential trade arrangements, see Krueger (1999).

154In addition, similar regional integration took place among Central American and Caribbean countries with, for example, the formation of the Central American Common Market and the Caribbean Community.

155For example, Chang and Winters (2002) analyze the impact of Mercosur on the pricing of nonmembers' exports to Brazil and conclude that the observed decline in export prices can be attributed to the effects of trade diversion.

156See, for example, Yeats (1997).

services regulation, and government procurement practices (Box 7.1).[157]

Second, regional trade agreements would have a greater positive impact if they were more comprehensive in scope. In addition to liberalization of trade in manufactured products, for example, only a few arrangements include trade in services or agreements on foreign direct investment regulations, competition policy, and other kinds of regulatory infrastructure that facilitate exchange and bring certainty to the economic environment. Binding these policy changes in an international agreement tends to better anchor the policy environment and to ensure that the reforms result in positive externalities for trade with partners that are not members of the arrangement.

The most important free trade initiative in the hemisphere is the Free Trade Agreement of the Americas (FTAA). Negotiations are under way among 32 countries in the region, led by the United States and Brazil, with a target date for agreement of 2005. Negotiations were initially to cover trade restrictions on manufactured goods, agriculture, and services, and to establish hemisphere-wide rules regarding intellectual property rights, subsidies, antidumping, countervailing duties, government procurement, investment, competition policy, and dispute settlement. There are considerable obstacles to overcome in these negotiations, however; and, as a result, the agenda has been scaled back from its original objectives. Following the Miami meeting in November 2003, a "menu-driven" approach is emerging, allowing each FTAA member to pick and choose from a list of commitments that has yet to be established. This may entail a correlation between benefits and obligations, undermining nondiscriminatory treatment not only vis-à-vis nonmembers but also within the FTAA. This new approach suggests a diminished, yet complex FTAA with some common standards and a set of plurilateral agreements. Nonetheless, the FTAA is still likely to yield fairly broad coverage of non-agricultural market access and help to chip away at remaining protective barriers in Latin America.

Barriers to Industrial Country Markets

Latin American countries continue to face significant barriers to their exports, and particularly agricultural products, to industrial country markets.[158] Agricultural support in major industrial countries tends to encourage the overproduction of agricultural products and result not only in fewer imports into industrial countries but also depressed international prices. Industrial country support includes market price supports; a variety of payments to farmers based on output, area planted, input use, historical payments, or farm income; and export subsidies. Total support to agriculture in member countries of the Organization for Economic Cooperation and Development (OECD) amounted to about US$305 billion—or 1.3 percent of OECD countries' GDP—in 2001.[159]

Estimates suggest that agricultural protection in industrial countries is particularly costly for Latin America. For example, estimates based on a general-equilibrium model of the international economy suggest that if U.S. agricultural subsidies and tariffs on field crops were cut by 50 percent, exports of these products from Latin America—Argentina and Brazil in particular—would rise by 9 percent.[160] Moreover, if Canada, the European Union, and Japan also cut subsidies and tariffs by 50 percent, Latin American exports of field crops would rise by about 20 percent. Latin American sugar producers would also benefit from further industrial country liberalization: if the United States removed 50 percent of the barriers to the U.S. sugar market, Latin American sugar exports would rise by 10 percent; and if Canada, the European Union, and Japan also removed 50 percent of their sugar barriers, the region's exports would rise by nearly 40 percent.

More broadly, although the conclusion of the Uruguay Round resulted in an overall reduction in tariff rates in developed countries, Latin American countries continue to face the effects of very high tariff rates—that is, tariff peaks and tariff escalation.[161] Developed countries have continued to have import tariff peaks not only in the agriculture sector but also in such sectors as processed foods, textiles and apparel, footwear and leather products, automotive and transport equipment, and electronic products.

Weak Domestic Trade Institutions and Infrastructure

Establishing the institutions and infrastructure to support international trade plays a critical role in developing a successful and competitive export sector. Weaknesses in these areas have tended to be obsta-

[157]Despite the positive results attributed in part to NAFTA, scope remains for further negotiations and liberalization under the agreement, particularly for rules of origin and manufacturing trade, agriculture, and the use of antidumping and countervailing-duty measures. For a detailed discussion, see World Bank (2003a).

[158]NAFTA has been the exception and has illustrated the benefits of improved market access on export growth.

[159]See OECD (2003).

[160]The model used for these estimates was the Global Trade Analysis Project (GTAP). For further details, see MacDonagh-Dumler, Yang, and Bannister (2002). Field crops include rice, wheat, grains, and oilseeds.

[161]See, for example, ECLAC (2003).

Box 7.1. NAFTA: Benefits and Challenges[1]

The North American Free Trade Agreement (NAFTA), signed by Canada, the United States, and Mexico in January 1994, was the first comprehensive free-trade agreement among advanced and developing countries. The agreement created the world's largest free-trade area in terms of total gross domestic product (GDP) and the second largest in terms of total trade volume, after the European Union.

NAFTA was broad in scope, eliminating the majority of tariffs and other trade barriers in its first 10 years and phasing out most remaining tariffs by 2008. Various provisions were included covering investment flows, financial services, government purchases, and protection of intellectual property rights. NAFTA also established a variety of unique mechanisms for resolution of disputes that supplemented existing World Trade Organization (WTO) mechanisms and also included side agreements on labor and environmental issues.

How has NAFTA affected Mexico?

- Separating the effects of NAFTA from the positive and negative shocks that affected Mexico over the past decade is difficult. Following the agreement, the U.S. economy experienced a prolonged boom, followed by the 2000 stock market collapse and subsequent recession. The Mexican economy also suffered a major financial crisis in the mid-1990s, from which the banking sector has slowly recovered. Subsequently, the implementation of sound domestic economic policies and the strength of the U.S. economy have played important roles in boosting growth in Mexico.
- Nonetheless, most studies suggest that NAFTA spurred a dramatic increase in trade and financial flows. (See the relevant figure.) For example, Mexico's exports to the United States and Canada tripled in dollar terms between 1993 and 2002. Although the growth of trade has slowed since 2000, Mexico's trade (exports *plus* imports) with its NAFTA partners accounted for about 40 percent of its GDP in 2002. The agreement also appears to have significantly altered the nature of trade flows, with a substantial increase in intra-industry trade between Mexico and its NAFTA partners. Similarly, NAFTA helped boost foreign direct investment (FDI) flows to Mexico, which rose from $12 billion during 1991–93 to roughly $54 billion during 2000–2002, with the share of NAFTA partners in total FDI flows to Mexico increasing from 50 percent in 1994 to roughly 80 percent in 2002.
- Increased trade and financial linkages have affected the dynamics of economic growth in Mexico in several ways. (See the relevant figure.) Contributions of exports and investment to GDP growth have increased substantially following the introduction of the agreement. In particular, the contribution of investment to GDP growth reached 3 percentage points during 1996–2002 as the average growth rate of investment rose to more than 8½ percent. Recent studies suggest that NAFTA induced a sizable increase in total factor productivity in Mexico, helping double GDP growth from an annual average of 2 percent during 1980–93 to 4 percent during 1996–2002.

How Has NAFTA Affected Mexico?

Source: Kose, Meredith, and Towe (forthcoming).
Notes: FDI denotes foreign direct investment. NAFTA denotes North American Free Trade Agreement.

[1] This box draws on Kose, Meredith, and Towe (forthcoming).

Box 7.1 *(concluded)*

- NAFTA appears to have been associated with significant changes in the Mexican business cycle. (See the relevant figure.) Mexico's output volatility has decreased by almost 30 percent, and the volatility of investment has fallen by more than 40 percent, since 1996. Business cycles in Mexico and the United States have become significantly more synchronized, with marked increases in the cross-country correlations of the major macroeconomic aggregates.

What challenges lie ahead for Mexico, and what are the lessons for other developing countries?

- Mexico's trade with NAFTA partners has slowed in recent years, and Mexico's output growth has also fallen sharply. This has reflected cyclical factors, including the U.S. recession and the initially halting recovery. At the same time, however, structural factors have been important. Mexico has been adversely affected by the health of the U.S. manufacturing sector, which has been the destination for most of Mexico's exports, as well as by the rapid expansion of the market shares of emerging market economies, particularly China, in the United States.

Mexico's experience under NAFTA illustrates that structural reforms are needed to sustain the benefits of comprehensive trade agreements. In Mexico's case, although there has been considerable progress in attaining financial and macroeconomic stability, there is also a clear need for measures to boost competitiveness in a number of areas. For example, Mexico has among the most rigid labor market institutions in Latin America, which discourage the development of the formal labor sector. The energy sector is another key concern, and measures are needed to facilitate investment and exploitation of new opportunities. Telecommunications remain highly regulated, driving up business costs. In the institutional area, judicial reforms are needed that would provide greater certainty to the legal process and enhance the rule of law. Finally, comprehensive tax reform is essential to reduce dependence on oil revenues and generate the resources needed to improve public infrastructure and education.

cles to trade in some Latin American countries. For example, with regard to institutions, despite progress made in recent years, improvements in customs administration are needed in a number of countries. Clearing customs efficiently is important for containing costs, particularly for assembly of products for re-export. Moreover, the proliferation of regional trade arrangements has complicated the process by adding requirements to administer rules of origin, preferential duties, and other discriminatory rules. As a result, the average delay in customs in Latin America is about nine days, compared with just five days in East Asian and Pacific countries.[162]

Other institutional weaknesses that have hindered trade flows include legal uncertainty about the enforceability of trade documents, such as bills of lading and letters of credit; corruption, particularly with regard to clearing customs; and complex and nontransparent administrative procedures. In addition, although many Latin American countries belong to international institutions such as the WTO, they participate less than fully in a number of agreements and make extensive use of developing country exemptions, restraining the momentum of liberalization.[163] Also, countries have been slow to adopt and enforce a number of scientific, technical, and phytosanitary standards that can be critical in promoting exports, particularly of agricultural products.

Trade-related infrastructure needs to be strengthened to facilitate the movement of goods across borders. Trade-related transactions costs are important in determining how successful a country is in participating in global trade.[164] Problems that add to trade costs include frequent reloading of goods; port congestion owing to inadequate facilities; the limited use of e-commerce, which adds to the cost of processing information; and relatively weak service sectors. For example, even in Chile, where exporters are less hindered than elsewhere in Latin America, weaknesses in infrastructure—such as the absence of tunnel access through the Andes in winter and inadequate port facilities—have held back export growth.[165] In many Latin American countries, further investment is needed to expand port facilities, implement new technology, and develop other infrastructure services. In this regard, the entry of foreign service providers can prove helpful in introducing new technologies and management practices to the domestic service industry. Latin America's reluctance to undertake meaningful market access com-

[162]World Bank (2003b).

[163]One aspect of this special treatment is the wide gap between tariff levels committed to ("bound") in the WTO and those actually applied, which further increases the uncertainty about future market access conditions.

[164]Evidence in World Bank (2003b) suggests that transport cost barriers to trade generally outweigh tariff barriers and that improvements in service-sector infrastructure would provide large gains from trade.

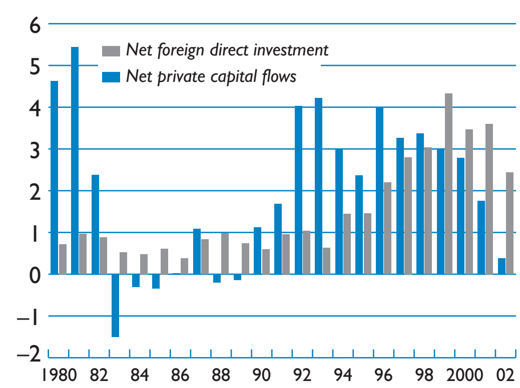
[165]See Macario (2000).

mitments under the WTO's General Agreement on Trade in Services (GATS) has not helped it to realize the full potential of such investment.[166]

Weaknesses in Macroeconomic Environment

Latin America's macroeconomic environment has also contributed to the region's disappointing trade performance. Overvalued real exchange rates and financial volatility have been particularly important. As discussed in Section IV, although exchange rate-based stabilization programs arrested inflation in the 1990s, a common result was persistent appreciation of the real exchange rate, which, in turn, promoted investment in nontradable goods and discouraged exports. Macroeconomic volatility also undermined investment and trade.[167] The volatility was driven not only by external developments, such as fluctuations in the terms of trade and capital flows, but also by domestic policy inconsistencies and recurring financial crises.

Figure 7.7. Latin America: Net Private Capital Flows
(In percent of GDP)



Source: IMF, *World Economic Outlook*, various Issues.

Capital Flows to Latin America

While the ratio of trade to GDP expanded modestly during the 1990s, channels of external financing reopened and capital flows to the region surged from the very depressed levels of the 1980s.

In a number of Latin American countries, capital account liberalization either accompanied or predated trade liberalization measures.[168] Capital accounts in Latin America were opened up beginning in the 1970s, with initial steps taken in Argentina, Chile, and Mexico. In the mid-to-late 1970s, capital account openness was further encouraged by large bank-based inflows related to recycling of Organization of Petroleum Exporting Countries (OPEC) oil surpluses that dominated flows to the region. Key capital account reforms centered on eliminating exchange controls and ending restrictions on foreign direct investment (FDI) and other capital flows.

During the 1980s debt crisis in Latin America, many countries imposed capital controls to forestall capital outflows. These controls were largely ineffective, and capital flight continued throughout most of the decade. Following these difficulties, efforts to liberalize capital accounts resumed in the late 1980s. In Mexico, for example, restrictions on foreign capital participation in investment were liberalized substantially; nonresidents were allowed to buy shares on the Mexico Stock Exchange; and resident firms were allowed to issue stocks in foreign markets, provided that they were registered on the national stock registry.[169] Subsequently, nonresidents were permitted to hold Mexican government bonds and privatization of banks was allowed.

Capital flows returned to the region beginning in the early 1990s owing to both domestic and international developments (Figure 7.7).[170] The return of private capital reflected, in part, the new structural reform agendas that had been put in place—including improvements in financial sector regulation. Privatization and increased scope for foreign ownership, particularly in the financial and energy sectors, also encouraged increased inflows. Moreover, improved macroeconomic policies in a number of countries succeeded, at least initially, in reducing inflation, narrowing budget deficits, and contributing to a more stable exchange rate. Together, these improvements in the domestic environment increased the creditworthiness of Latin American borrowers. At the same time, the Brady debt restructuring initia-

166See Adlung (2000).

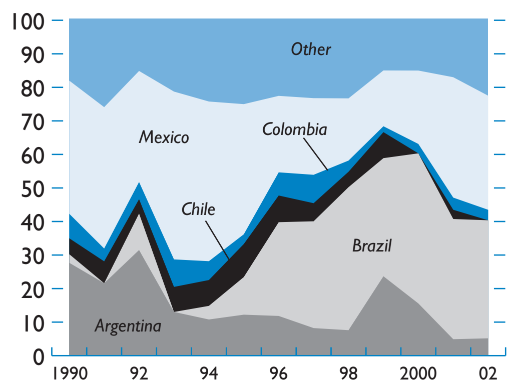
167See, for example, Rodrik (1999).

168Empirical evidence on the economic benefits of capital account liberalization is mixed. Based on a survey of the literature, Edison and others (2002) conclude that the evidence does not strongly point to a general result regarding the consequences of capital account liberalization, although there is some mixed evidence that liberalization boosts long-term economic growth. These effects seem to be most pronounced in East Asian countries.

169For a detailed discussion of capital account liberalization in Mexico and other countries, see Ishii and Habermeier (2002).

170For a detailed discussion of the behavior of capital flows to Latin America over the last two decades, see Fernandez-Arias and Panizza (2001) and Griffith-Jones (1998).

Figure 7.8. Selected Latin American Countries: Net Foreign Direct Investment (FDI) Flows
(In percent of total net FDI flows to Latin America)



Source: IMF, *World Economic Outlook*, various Issues.

tives reduced the debt overhang, which increased confidence in countries' economic prospects and improved their market access.

International developments also boosted capital flows to Latin America. Recessions in the industrial countries in the early 1990s and the decline in U.S. interest rates created abundant international liquidity, prompting investors seeking higher returns to channel more funds to emerging markets, including Latin America.[171] Financial liberalization in the industrial countries and the trend toward international diversification of institutional portfolios also improved the availability of funds to the region.

Together, these factors resulted in a surge of capital flows to Latin America on a scale similar to that observed in the 1970s. Compared with the 1980s, the inflows in the 1990s were concentrated more in portfolio flows (both debt and equity) and substantially less in bank borrowing.

In addition, FDI rose as a share of inflows, particularly in the second half of the 1990s (see Figure 7.7)—an encouraging development, since empirical evidence has shown that FDI can have a positive impact on growth.[172] Foreign direct investment in Latin America increased from an average of about ¾ of 1 percent of GDP in the 1980s to around 1 percent in the first half of the 1990s and then jumped to around 2½ percent of GDP in the second half of the 1990s before peaking at more than 4 percent in 1999. Although privatization was a key development fueling the pickup in FDI, the foreign acquisition of assets—that is, foreign investment in large private domestic enterprises in the manufacturing, electricity, and oil sectors—was important as well. On a country basis, Mexico accounted, on average, for about one-third of net FDI flows to Latin America over the 1990s, although this share varied from a high of 50 percent in 1993 to a low of around 20 percent for several years following the 1994–95 Mexico crisis (Figure 7.8). By the end of the 1990s, net FDI flows to Brazil accounted for a large share of the total flow to Latin America.

Volatility in capital flows continued in the 1990s, again subjecting the region to costly reversals and "sudden stops." When access to capital markets closed, real activity collapsed as credit dried up and production came to a halt. The crises inside and outside the region—the Mexican peso crisis in 1994–95, the Asian crisis and its after-effects during 1997–99, and the Argentine crisis beginning in 2001—were all accompanied by sharp retrenchments in flows, often with severe macroeconomic effects. For example, Fernandez-Arias and Panizza (2001) estimate that the difference in Latin America's GDP growth rates between years when it had access to financial markets and years when it did not was about 2 percentage points.

Some of the volatility of capital inflows reflected weaknesses in prudential guidelines in developed markets, which did not encourage adequate differentiation among emerging market borrowers according to risk. When risk perceptions worsened, the reversal of flows was immediate, with important contagion effects across countries. In addition, lenders tended to reduce apparent risks by investing in short-term and/or foreign currency debt or sovereign debt. Shifting market-risk exposure to governments did not reduce overall risk, however, but instead transformed it into (less visible) default risk. When the implications were belatedly recognized in markets, a sharp drop in market access and jumps in yield spreads led to crises.

The opening of capital accounts in a number of Latin American countries took place before other structural reforms—particularly with regard to the financial sector—were firmly in place.[173] As dis-

[171]For a discussion of how movements in the supply of external financing have triggered lending booms in emerging market countries, and in Latin America in particular, see Calvo, Reinhart, and Leiderman (1996) and Arora and Cerisola (2001).

[172]FDI can have a positive impact on growth, especially in countries where education levels are high, thereby allowing FDI spillover effects to be exploited. The pickup in FDI flows was not unique to Latin America, since other emerging market countries were also recipients. See, for example, IMF (2001).

[173]For a detailed discussion of capital account liberalization, see Ffrench-Davis (2000); Edwards (2001); Hanson (1995); and Arteta, Eichengreen, and Wyplosz (2001).

cussed in Section V, the confluence of increased access to capital markets, weak regulatory and accounting standards, and inadequate banking supervision resulted in an increase in risky loans in financial systems, heightening vulnerability to economic shocks. Moreover, capital account liberalization occurred in some countries where the macroeconomic policy regime was insufficiently robust to manage the strains associated with volatile capital flows. Sudden reversals of capital flows typically exerted heavy pressure on the foreign exchange market and forced the authorities to devalue or abandon the exchange rate anchor altogether, as discussed in Section IV. Experiences in Latin America, and other regions as well, have illustrated the importance of sequencing and coordinating capital account liberalization with other policies, and particularly with strengthening of domestic financial systems to improve the ability of financial and nonfinancial entities to manage the risks associated with capital inflows.[174] The optimal sequencing of capital account liberalization is complex, however, and varies widely depending on the initial country conditions.

Low Trade Shares and Volatile Capital Flows Amplified Vulnerabilities

Weak trade opening and volatility in external financing flows—individually and in combination—amplified crisis vulnerabilities in Latin America. The structure of trade in Latin America heightened the region's vulnerability to external shocks. First, as already discussed, in a number of countries exports remained concentrated in a few primary commodities. With relatively high volatility in world commodity prices, economies generally remained highly vulnerable to terms of trade shocks that amplified underlying macroeconomic weaknesses. Second, increases in trade flows among close neighbors resulting from regional arrangements raised the exposure and vulnerability of these countries to common shocks and spillovers. The relatively high intraregional trade flows, therefore, may have amplified, rather than eased, shocks to the region.

More broadly, Latin America's relatively low trade openness was a key source of vulnerability in the region. Indeed, evidence based on the experience of the last twenty-five years suggests that financial crises have occurred more frequently in countries that are less integrated into the world trading system.[175]

Why does higher trade openness tend to reduce the frequency of crisis?[176] First, openness to trade tends to force an economy to become more flexible and thereby build greater resilience with respect to shocks. Second, trade integration can play an important role in increasing a country's ability to service its external debt. With a higher export-to-GDP ratio, a given exchange rate depreciation will provide a country with a greater opportunity to earn additional foreign exchange to service debt denominated in foreign currencies. Thus, a higher export ratio enhances the likelihood that a country will be able to service its foreign currency debt and, therefore, reduces the prospects of a reversal in capital inflows. The level of Latin America's external debt was similar to, if not lower than, those of other regions (Figure 7.9, top panel). The external debt was, however, primarily concentrated in public, rather than private, debt (Figure 7.9, middle panel); and the ratio of Latin America's total external debt to its exports far exceeded that of emerging Asia (Figure 7.9, bottom panel), with Uruguay and Argentina registering debt-to-export ratios in excess of 500 percent (Figure 7.10).

Crisis vulnerabilities were further exacerbated by a strong "fear of floating" in the region. Governments generally resisted exchange rate depreciation, owing to their past experience with exchange rate pass-through fueling inflation and the potential adverse liquidity and solvency consequences of highly dollarized balance sheets. With exchange rates in Latin America constrained, adjustments in trade competitiveness would have required significant declines in nominal domestic wages and prices.

Lessons, Policy Responses, and Challenges

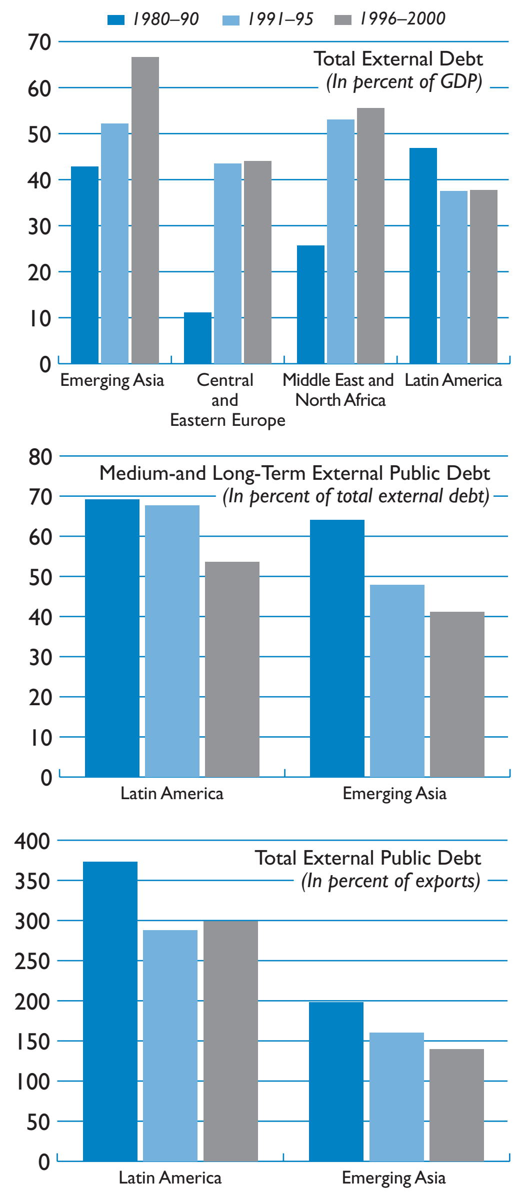
Although Latin America made considerable progress in liberalizing trade during the 1990s, the extent of integration remains limited. Moreover, in many Latin American countries, the mismatch between a high degree of capital account openness and a low degree of trade openness left the region ill-equipped to deal with shocks and, in particular, the

[174]See Ishii and Habermeier (2002) and Nsouli, Rached, and Funke (2002) for a discussion of coordinating and sequencing capital account liberalization.

[175]As noted in Morsink, Helbling, and Sgherri (2002), developing countries that are less integrated are about 20 percent more likely to experience a debt default and 30 percent more likely to have a currency crisis than the average developing country. Sgherri (2002) shows that the inverse relationship between trade integration and crises remains robust under alternative econometric specifications.

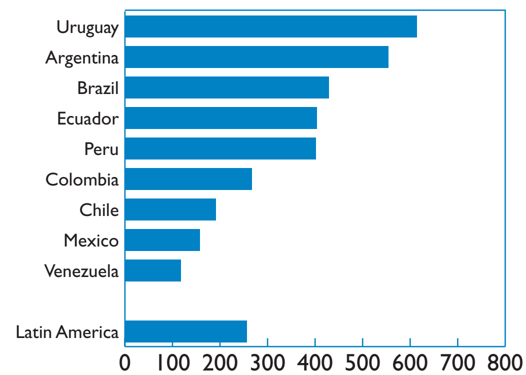
[176]This subsection draws on Catão (2002).

Figure 7.9. International Comparison: External Debt



Sources: Catão (2002); and World Bank, *Global Development Finance*, various issues.

Figure 7.10. Selected Latin American Countries: External Debt, 2000
(In percent of exports)



Source: IMF staff estimates.

volatility inherent in capital flows. The relatively low level of exports in Latin America made it more difficult to achieve trade surpluses through exchange rate depreciation, while capital outflows could quickly be triggered by a loss of confidence, making debt payment more difficult. In recent years, however, considerable progress has been made in addressing these underlying vulnerabilities, with efforts made to liberalize trade and create greater financial resilience.

Building on the progress they made during the 1990s, Latin American countries have pushed ahead with trade liberalization in recent years. Many countries have continued to pursue liberalization through multilateral, bilateral, and unilateral channels— efforts that bear fruit by contributing to trade openness and by spurring broader reforms.

- The greatest potential benefit would arise from successful multilateral trade negotiations that could bring improved access for key Latin American exports, such as agricultural and textile products, in advanced countries. Indeed, many Latin American countries have actively participated in WTO negotiations. Recently, there has been a renewed momentum in the talks, with Brazil and other Latin American countries taking a prominent role in the search for common ground. The importance of a successful Doha round cannot be overstated. Estimates of the total gain from a Doha round agreement range from several hundred billion to a trillion U.S. dollars over the next decade or so, with the principal beneficiaries being developing countries.[177]

[177]Krueger (2004).

- Bilateral trade agreements can also play a beneficial role in expanding trade. For example, Chile's Free Trade Agreement with the United States, which became effective in January 2004, eliminates more than three-quarters of all tariffs immediately, with the rest to be phased out over 12 years. In addition, in mid-2004, five Central American countries (Costa Rica, El Salvador, Guatemala, Honduras, and Nicaragua) and the Dominican Republic signed the U.S.-Central American Free Trade Agreement. Other countries have also signaled their interest in similar agreements with the United States; and negotiations have begun with Colombia, Peru, and Ecuador.

- Further steps have been taken in forging trade agreements between the European Union (EU) and many Latin American countries. For example, the EU signed free-trade agreements with Mexico (1999) and Chile (2002), while negotiations between Mercosur and the EU have continued. Furthermore, it is expected that negotiations will be opened between the EU and Central America and the Andean Community.

- Progress continues on broader regional trade negotiations including the Free Trade Agreement of the Americas, which would progressively eliminate barriers to trade and investment among countries in the Western Hemisphere.

Aside from progress in designing and finalizing multilateral and bilateral agreements, there remain considerable scope and benefits for Latin American countries to encourage trade opening by unilaterally easing their own restrictions, particularly with regard to tariff escalation, nontariff barriers, and the significant remaining restrictions on services trade. Unilateral liberalization may have been slowed in recent years by the ongoing regional and multilateral negotiations.

More broadly, further development of trade institutions, as discussed in this section, will also help to support trade growth and openness. The importance of such infrastructure, including institutions to establish or adapt standards and promote conformity, is illustrated by the experience in Central America. For example, efforts in Costa Rica have yielded a comprehensive infrastructure for assessing conformity to technical standards. Progress is also under way in developing customs-administration capacity. For example, in Brazil, a number of important trade-related institutional improvements have been implemented, including a centralized electronic system to register, monitor, and control foreign trade operations. Further development of transportation infrastructure—including roads and ports—will help alleviate bottlenecks in a number of countries.

The full impact of increased trade openness will depend on the progress made on complementary reforms, especially to entrench a more enabling business environment that would enhance labor mobility across economic activities, in Latin America. At the same time, trade reform also requires the implementation of well-targeted and temporary adjustment-assistance programs to compensate workers in sectors that will not benefit from the expected changes in relative prices. In many cases, adjustment-assistance programs should be focused on households or small firms that are *net* producers of import-sensitive agricultural commodities and/or on policies to enable the diversification of regions where these commodities are produced.

To better cope with the volatility of capital flows, progress continues to be made across the region in strengthening financial systems and underlying macroeconomic frameworks:

- As discussed in Section V, many countries have taken critical steps toward improving risk-management practices of financial institutions by shoring up prudential regulations and supervision.

- For example, central banks and supervisors are generally acquiring increased authority to deal with problem banks; initial capital requirements are being raised for the opening of new banks; and banks are being required to implement risk-control systems. Moreover, the broader institutional framework of the financial sector has been strengthened. For example, Mexico improved accounting standards, and Brazil required external account audits with strict rotation rules.

- More flexible exchange rates in many Latin American countries have contributed substantially to improving macroeconomic flexibility and the ability of countries to better weather the strains associated with surges and reversals in capital flows.

Looking ahead, Latin America's progress toward greater trade openness and strengthened financial systems and underlying macroeconomic frameworks is likely to contribute to greater resilience with respect to external shocks—and, in particular, to volatile capital flows—than was seen in the past.

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