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Trade Liberalization and Growth: Recent Experiences in Latin America*

Manuel R. Agosin and Ricardo Ffrench-Davis

INTRODUCTION

I**N** recent years, many Latin American countries (LACs) have embarked upon trade liberalization drives. This article reviews the radical changes in trade policy which this has entailed, together with the current and foreseeable results, and offers some policy recommendations regarding complementary measures.

The first sustained experience with trade liberalization in recent decades was in Chile, which launched a process in the 1970s that, by the end of that decade, had made its economy one of the most open in the world.

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By the mid-1980s, after more than half a century of protectionism, a tendency towards radical change in development strategies and policies of several LACs was becoming evident. As early as 1983, Costa Rica set out on a path designed to effect a gradual transition from the model of import-substitution, which it had been implementing at both national and Central American levels, to a model oriented towards forging a more dynamic position in the international economy. Shortly thereafter, in 1985, Bolivia and Mexico embarked upon relatively fast-paced liberalization programs as well.

With the early 1990s, several other countries also joined in this movement, including Argentina, Brazil, Peru and Venezuela. Even Colombia, which had undertaken a gradual program in 1990 that was designed to open up its economy over a 4-year time span, decided the following year (1991) to step up the pace of this liberalization effort so that it could be completed in 1992. Thus, although they were moving forward at different speeds, it was clear that the countries of the region had reached a major turning point.

Implicitly or explicitly, each country had to decide the profile of the process of liberalization, what to liberalize and by how much, in what sequence, and what other policies it should adopt to ensure that its particular liberalization scheme would contribute to development (see Section I). In this article we will attempt to come up with some answers to those questions, based on recent events in Latin America.

Section II reviews some part of the voluminous literature on Asian export-oriented economies (the Republic of Korea, Taiwan and, more recently, Indonesia, Malaysia and Thailand) so that the more recent experiences of the Latin American countries (LACs) can be compared with others of a longer standing and very different character. The greatest differences between the liberalization efforts of the LACs and the way in which Asian countries have opened up their economies are that most Latin American liberalization programs have been carried out rapidly with the state playing a passive role, whereas the opening of the Asian economies has been a long,

state-led process involving construction of a production apparatus oriented towards international markets.¹ When imports were liberalized in Asia, the economy's structural transformation had already been advancing, and exports had been on the rise for a long time. These conditions were buttressed, in most cases, by macroeconomic equilibria and much higher ratios of investment. In contrast, the drastic import liberalization carried out in Latin America was launched during the initial stage of the various internationalization strategies which, in turn, often coincided with stabilization processes and low rates of capital formation.

Section III examines some of the key elements of these reform programs in the light of the conditions that are needed to open up an economy so as to stimulate its long-term development. Clearly, in the world of today, economies must achieve international competitiveness and a more dynamic position in world markets if they are to secure sustained development. Consequently, restrictions on imports must be reduced. Regardless of whatever benefits may have been provided on the domestic front in the past, the old sort of protectionist policy is undoubtedly an obstacle to development in today's environment.

The basic problem with protectionist policies of the past was that, in the final analysis, policymakers did not know what they were promoting, nor why (French-Davis, 1986). As Fritsch and Franco have noted, protection is not only very costly but, when indiscriminately applied, may ultimately end up by not protecting anything in particular (Fritsch and Franco, 1993: 32). The protectionist policies of the past, in Latin America as well as other regions, were often exploited by private concerns in search of economic rents. In many cases no social benefits were evident, and the resulting industrial structures tended to be not competitive on the international market and to remain dependent on government protection indefinitely. It should also be recognized, however, that these schemes permitted the establishment of industrial sectors that have served as the basis for subsequent forms of development that are more strongly oriented towards international competitiveness than was possible previously.

In order for trade reforms to be successful, the value added by the creation of new activities must exceed the value subtracted by the destruction (or elimination) of existing activities. This tends to be associated with an increase in exports that is greater than the decrease in import substitution;² that export activity must have positive spillover effects for the rest of the economy, which will depend upon the degree of diversification and the amount of value-added they contain; and that international competitiveness must be attained through a continuing increase in productivity, rather than by means of low wages and/or rising subsidies or tax exemptions.

This is why it is essential that economies be opened up in a way that (1) does not entail indiscriminate destruction of existing installed capacity and (2) will permit effective switching of productive activities. This process also needs to be coupled with a sustained, credible change in relative prices favorable to the production of exportables, and with improvement in, or creation of, the markets and institutions essential to a steady increase in productivity: *via* labor training, improvements in infrastructure, incentives for technological innovation, development of long-term segments of capital markets, and enhanced ability to negotiate access to external markets.

Generally speaking, this has not been the focus chosen by Latin American countries in launching their trade liberalization initiatives. The specific approaches adopted tended to suffer from serious shortcomings in three crucial areas. First, unilateral bids to open up an economy would make sense in an open, dynamic, competitive world economy, but are less advisable in an international economy where (a) protectionism is still a very real factor, (b) trade is growing slowly, and (c) a strong trend towards the formation of regional trade blocs is observed (see ECLAC, 1995: Chapter II). Second, this process is based on static comparative advantages and short-term gains in resource allocation, but it becomes vulnerable if it is concentrated in areas of activity whose markets are more sluggish and less active in terms of technological innovation. Third, in financial markets and on the capital account of the balance of payments,

the recent move toward deregulation of capital markets has hampered the reallocation of resources that was supposed to be brought about by trade liberalization because, under the conditions prevailing in the 1990s, it has been conducive to sharp appreciation of exchange rates and high real interest rates. These factors discourage the productive investment needed to produce structural change and cause resources not only to move away from the production of tradeable but to concentrate more in purely financial investment.

I. TRADE LIBERALIZATION PROGRAMS IN LATIN AMERICA

MANY countries in the region have undertaken trade liberalization reforms in recent years (see Table 1). With the exception of Costa Rica, 8 of the 9 countries shown in Table 1 introduced reforms that could be described as both drastic and abrupt. Moreover, in 7 of these 8 countries (with Chile the lone exception), import liberalization was carried out over a period of just 2-3 years (1989-90 to 1992-93). The bulk of Argentina's liberalization program was implemented largely in April 1991, whereas the process took 5 and a half years in Chile: from late 1973 to mid-1979.

In all cases, albeit to varying extents, quantitative restrictions have been dismantled, and tariffs have been lowered significantly. In general, the amount of tariff protection provided differs considerably from its pre-reform levels, and the spread of rates of effective protection has diminished substantially. However, no country has yet adopted a tariff rate of zero, while only Chile has a uniform tariff (currently 11%). Bolivia follows close behind, with a tariff system consisting of only two brackets and a 10% maximum. All the other countries have a number of different tariff rates, with ceilings that range from 10% to 35%, and with average rates of between 7% and 18%. These regional trends in trade policy have been complemented by free trade agreements, either bilateral or multilateral, which cover a wide spectrum of items.³

Table 1. Latin America (Selected Countries): Summary of Unilateral Trade Liberalization

Country	Programme starting date	Maximum tariff		Number of tariff rates		Average tariff		Non-tariff barriers	Variation in real exchange rate change date ^a
		Ini- tially	Year- end 1993	Ini- tially	Year- end 1993	Ini- tially	Year- end 1993		
Argentina ^b	1989	65	30	3	39 ^c	15 ^c	In 1988 the value of industrial production subject to restriction was reduced from 62% to 18%. In 1989-1991 non tariff restriction, temporary additional duties and specific duties were eliminated.	-49	
Bolivia	1985	150	10	2	12 ^d	7 ^d	With few exceptions, all import bans and license requirements were abolished.	92	
Brazil	1988	105	35	7	51 ^e	14 ^e	In 1990 the list of banned imports and prior-licensing requirements were eliminated. However, national-content requirements for intermediate and capital goods will be maintained.	44	
Colombia	1990	100	20	4	44 ^d	12 ^d	Nearly all restriction concerning the prior-licencing requirement were lifted in late 1990.	-4	

Table 1. Continued Latin America (Selected Countries): Summary of Unilateral Trade Liberalization

Country	Programme starting date	Maximum tariff		Number of tariff rates		Average tariff		Non-tariff barriers	Variation in real exchange rate ^a
		Ini- Year- end 1993	tially end 1993	Ini- Year- end 1993	tially end 1993	Ini- Year- end 1993	tially end 1993		
Costa Rica	1986	100	20	4	27°	14°		Import permits and other restrictions were phased out in 1990-1993.	10
Chile ^f	1973	220	10	1	94°	10°		In the 1970s quantitative restrictions on imports were eliminated as well as price bands.	-10
Mexico	1985	35	11	1	35°	11°		Price bands were re-introduced and the antidumping system was established.	32
	1985	100	20	3	24°	12°		The coverage of import permits was reduced from 92% of foreign purchases in June 1985 to 18% in December 1990, and official import prices were eliminated.	-15
Peru	1990	108	25	2	66°	18°		Import licenses, authorizations, as well as 28 quotas and bans, were eliminated in September 1990.	

Table 1 Concluded. Latin America (Selected Countries): Summary of Unilateral Trade Liberalization

Country	Programme starting date	Maximum tariff		Number of tariff rates		Average tariff		Variation in real exchange rate change date ^e
		Ini- tially end 1993	Year- end 1993	Ini- tially end 1993	Year- end 1993	Ini- tially end 1993	Year- end 1993	
Venezuela	1989	135	20	41	4	35 ^d	10 ^b	The number of categories subject to restrictions was reduced from 2,200 in 1988 to 200 in 1993. Specific duties, which in some cases raised the maximum tariff to 940%, were abolished.

SOURCE: ECLAC (1995), table V.1.

a - From the year before the liberalization programme began up to 1993; the exchange rate for exports has been used.

b - Includes surcharges.

c - Weighted by domestic production.

d - Weighted by imports

e - Simple average of all tariff items.

f - Chile's first trade liberalization programme was completed in 1979. The uniform tariff of 10% remained in force until 1982. Thus, the information in the first row is for that period (1973-1982). The second row contains information on the reduction of import tariffs, which, after rising to 35%, were successively reduced to 20%(1985), 15%(1988) and 11%(1991).

In a number of countries, measures to liberalize trade have been accompanied by liberalization of the capital account as well. Under the conditions prevailing since the beginning of the 1990s, when international capital markets began, once more, to take a positive view of the Latin American countries, liberalization of the capital account has prompted considerable appreciation of exchange rates (Calvo, Leiderman and Reinhart, 1993; ECLAC, 1995: Chapter XI) just when trade reforms were in urgent need of depreciation instead. Some countries (Chile and Colombia) have been more successful than others in countering this pressure on their currencies; in order to do so, however, they have resorted to foreign exchange controls and other heterodox forms of "financial engineering".⁴

In the subsections that follow, we will examine reforms recently implemented in three countries of the region within the framework set out below. These three countries (Chile, Mexico and Bolivia) have been chosen because their reforms have been in place long enough for their effects to be reflected in economic performance, thereby providing a basis by which to evaluate the impacts made on growth and investment.

1. The Framework for an Analysis of Strategies of International Insertion

Trade reforms are usually undertaken as part of a wide-ranging process of change, in which international competitiveness and exports play a leading role. The main instrument of reform has been a rapid, indiscriminate liberalization of imports. The aim was, and is, to expose producers of importables, which had frequently benefited from high levels of protection, to outside competition. It was expected that this would result in higher productivity, less inefficiency, the absorption of new technologies, and an increase in specialization. Producers that failed to adapt to outside competition would be crowded out of the market, and the resources freed up by their displacement would then be swiftly absorbed by other activities, primarily the production of exportables.

In this scenario, exports received indirect encouragement from the reduced cost and wider range of importable inputs which thus become available, and from depreciation of the exchange rate that this liberalization of imports would supposedly prompt in the foreign exchange market. The reaction of import-substituting activities will depend on the extent to which relative prices change, the rapidity of that change, and how well the relevant producers are able to adjust. It is more effective if producers can be given the requisite time for restructuring, though no more than is strictly necessary, so that they will find themselves in the situation of being actively pushed to change. For example, if a tariff is redundant, all the water can be eliminated very quickly, but the reduction of utilized effective protection should be paced to allow producers to introduce innovations, increase their level of specialization, and reallocate their resources. The pace of the adjustment is dependent upon two factors: (1) the credibility of the timetable for change, and (2) how much access producers have to the set of resources needed for restructuring. These factors help determine whether exposure to competition will function as a creative, or a destructive, process.

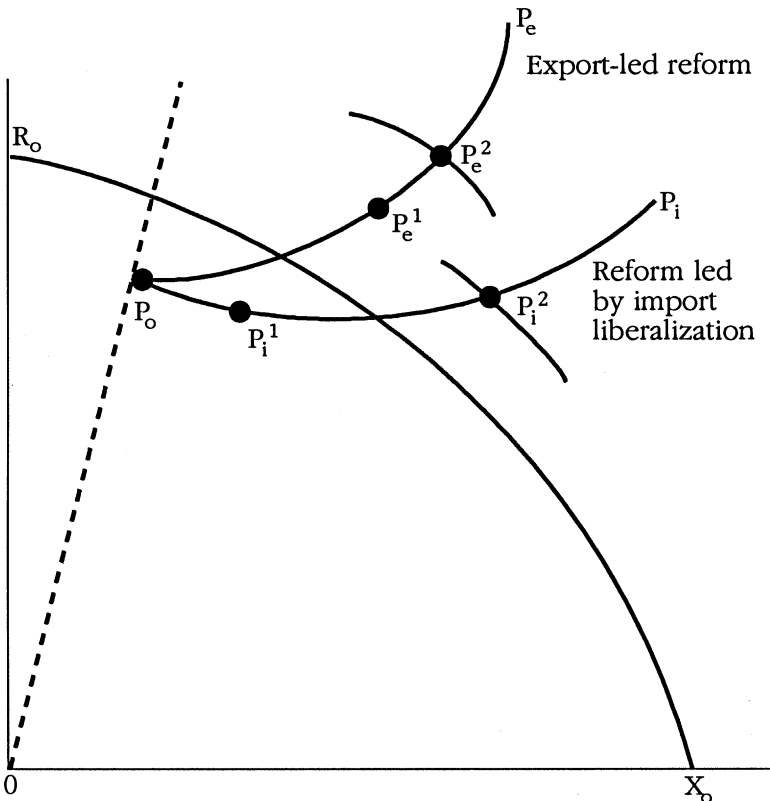
How exports react will depend on how much use is made of importables, and on how such goods had been dealt with in the past under the pre-reform trade system. Imports of inputs and capital goods by exporters have often benefited from tariff exemptions; nevertheless, in several cases, exports have been discouraged by inoperative, or arbitrary, trade restrictions.

The real exchange rate is a decisive factor in determining the response of production (both of exportables and importables). In order for a reform to be successful, the net effect of the changes made in incentives must be to boost the production of tradeable. Ability to restructure will also depend on the overall dynamism of investment and technological innovation, the supply of trained manpower, the features of the domestic capital market, the existing infrastructure, and the degree of access to external markets.

The combination of changes in relative prices, their credibility, and their pace of change (gradual or rapid), and in the macro- and meso-economic context in which reforms are implemented, will determine whether their effect on the allocation of resources will be predominantly positive or negative.

There are two broadly competing alternatives here: *either* the restructuring process can start out with an expansion of the production frontier, as has occurred in the newly industrializing countries (NICs) of Asia, *or* it can begin with a drop in economic activity and form part of an adjustment process that takes place below the production frontier. Both are depicted in Figure 1.

Figure 1.



In Figure 1, the X axis represents the value added in the production of exportables and the R axis represents the rest of the gross domestic product (GDP) (the sum of importables and non-tradeables). R_0X_0 is the initial frontier and P_0 is the starting point of actual production, below the frontier, which entails a low export coefficient and some degree of inefficiency in resource allocation. Within the framework of a dynamic expansion of the production frontier, the reforms should bring effective production closer to that frontier and should shift the output mix towards a larger share of exportables.

In an export-led strategy, in which the liberalization of imports plays a secondary supporting role (as in the case of the dynamic economies of East Asia), the adjustment process will tend to follow a path such as that described by the curve P_0P_e . This curve denotes a more than proportional increase in X together with a moderate growth rate for R, within the context of an expanding production frontier and a gradual increase in the efficiency of existing firms. Thus, the economy is positioned on, or near, a steadily expanding production frontier.

The curve P_0P_i denotes a different strategy, similar to that used in Latin America; this approach is led by import liberalization and involves the bankruptcy of a significant portion of import-substituting firms, together with a gradual increase in exports. These "desubstitution" pressures dominate adjustment during the early stages of the process, and the economy will therefore be positioned below the production frontier. This fact tends to discourage investment, which will, moreover, force the frontier to remain stationary during the initial years of the reform.

With this second strategy, it is probable that the firms who survive will tend to be, on average, stronger and more dynamic than in the first case. During the early years of the adjustment, however, the *volume* of productive resources available and their *rate of use* will be lower, owing to the higher rate of bankruptcies and downscaling of activity; the underutilization of resources will thus be greater, and the stimulus for total investment will be weaker. Therefore, a higher degree of

microeconomic efficiency will tend to be combined with a lower degree of macroeconomic efficiency. The hysteresis of the process dictates its end result, since what happens during the transition will have a determinant effect upon the level of well-being, and on the production structure, that emerges when the adjustment process is completed.

Of course, there is room for a large number of variations in these two options in the process of changing production patterns. Even within each product category, different intertemporal trends will probably be observed. There will also be crossovers between categories: import-substituting enterprises may be converted, in part or in whole, into importers, or — in response to reforms — may become exporters (Katz, 1993). For the sake of this discussion, however, we have focused on two sharply differentiated alternatives in an effort to characterize two opposing styles of internationalization.

Figure 1 illustrates these two alternative strategies, whose paths and end points are represented by the points of production P_i^2 and P_e^2 . Both exhibit sharp increases in X but very different results for R . The point P_e^2 is associated with economies such as those of Japan, Korea and Taiwan, whose GDP has shown strong growth over an extended period of time and which maintain an X -led economic growth. During the 1960s and 1970s, Brazil's growth curve was characterized by a more even rate of expansion in X and R (in the vicinity of the prolongation of OP_0). Chile's situation, on the other hand, is depicted more accurately by P_i^2 , with a steep increase in X but the stagnation of R as compared to output in P_0 : between 1981 and 1989, X rose substantially (a 51% increase in real exports of goods and services *per capita*) whereas R climbed slowly, in absolute terms, and actually decreased in *per capita* terms (the production of importables rose while the production of non-tradeable fell). Towards the end of the process, however, rapid growth emerges in R as well (as happened between the late 1980s and 1994).

2. Chile

Chile's trade liberalization scheme is the oldest and the longest continuously-applied program in the region. In late 1973, before the introduction of reforms, Chile's foreign trade was subject to a great deal of government control: nominal tariffs averaged 94% and ranged from 0% to 750%; countless non-tariff barriers were in place, including the requirement of large prior deposits for 60% of all imports and the discretionary authorization, by the Central Bank, of exemptions to that restriction; and a complicated multiple exchange-rate system was in place that involved 8 different official rates, with a 1,000% difference between the lowest and the highest (Ffrench-Davis, Leiva and Madrid, 1992; Meller, 1992).⁵

A. *The sweeping reforms of the 1970s.* As part of a far-reaching scheme for handing over the vast majority of economic decisions to market forces, trade policy reforms were launched in 1973 that included elimination of all non-tariff trade barriers, a sharp reduction in tariff levels, and establishment of a single exchange rate. Although it was not an initial goal of the program, a low, uniform tariff (10%) had also been established by June 1979.

During the first two years of the trade liberalization program, real devaluations of the government-controlled exchange rate offset the reduction in the average nominal level of protection (see Table 2). This gave a strong boost to exports other than copper and afforded some protection for the more efficient import-substituting activities. In 1976, however, the overall direction of fluctuations in the real exchange-rate began to show a lag. One main reason for the lag was that exchange-rate policy gradually shifted away from support for the opening up of the economy and towards the control of inflation. This trend reached its peak in 1979 when the nominal exchange-rate was fixed in an effort to anchor domestic inflation to the international rate as rapidly as possible.

Table 2. Chile: Average Tariff and Real Exchange Rate, 1973-1994

Year	Average tariff ^a (percentages)	Real exchange rate ^b (1980=100)	
		All countries	Excluding Latin America
1973	94.0 ^c	-	110.0 ^c
1974	75.6	-	115.2
1975	49.3	-	156.2
1976	35.6	-	126.6
1977	24.3	-	105.6
1978	14.8	-	117.2
1979	12.1	-	114.6
1980	10.1	-	100.0
1981	10.1	-	85.0
1982	10.1	-	98.7
1983	17.9	-	118.5
1984	24.4	-	122.0
1985	25.8	-	152.2
1986	20.1	171.8	171.8
1987	20.0	179.2	179.0
1988	15.1	191.0	186.1
1989	15.1	186.6	174.9
1990	15.1	193.6	170.4
1991	13.1	182.8	164.2
1992	11.1	168.2	152.0
1993	11.1	166.9	149.4
1994	11.1	162.5	142.7

Source: French-Davis, Leiva and Madrid (1991) and Central Bank of Chile.

a - Simple average, excluding preferential arrangements such as those negotiated with the Latin American Integration Association (ALADI) and Mexico.

b - Annual average. The external price index used for the heading "All countries" was constructed on the basis of the following countries, on weighted by share in Chilean trade: Argentina, Brazil, Canada, France, Germany, Italy, Japan, Peru, Republic of Korea, Spain, United Kingdom and the United States. The heading "Excluding Latin America" excludes Argentina, Brazil and Peru. For the years up to 1985, the information was taken from French-Davis, Leiva and Madrid (1991); from 1986 on, it was obtained from the Central Bank of Chile. For methodological reasons, the "All countries" data is presented only from 1986 on.

c - December 1973.

The opening up of the capital account, in combination with the high level of liquidity of the international capital markets, constituted another reason for the currency to appreciate. Beginning in 1977, there was a gradual relaxation of the quantitative limits that had been placed on the amounts which Chilean banks could borrow abroad in order to finance local lending in domestic currency (in fact, by mid-1979, these were eliminated altogether). Restrictions regarding minimum borrowing terms were also relaxed until they were eliminated entirely in 1982. Heavy capital inflows to Chile, where local-currency interest rates were considerably higher than international rates, buoyed up the real appreciation of the peso (Ffrench-Davis, Leiva and Madrid, 1992).

Interestingly enough, in 1979, when the trade liberalization drive was brought to completion and a uniform 10% tariff was established, the real exchange-rate hovered at almost the same level that had been in effect back in 1974 when the liberalization process first began. Although there had been a great deal of water in the average nominal tariff (94%) in existence at the beginning of the liberalization process, and the amount by which domestic prices exceeded international prices was certainly smaller, the fact remains that such a sharp reduction in tariffs was unprecedented in Latin America at that time. Basic trade policy theory would have indicated a need for a compensatory devaluation; policymakers initially asserted the same, but actually did just the opposite in the end. In the three years that followed completion of the import liberalization program, appreciation accelerated, which had a severe dampening effect on the production of tradeable (Ffrench-Davis, 1986).

B. Rectification of the reforms in the 1980s. The domestic and balance-of-payments crises that hit Chile in 1982 as a result of a combination of errors in economic management plus three severe external shocks (an increase in interest rates, a drop in copper prices, and then the suspension of external credit) caused aggregate demand to fall by 27%, and GDP to shrink by over 15%, between 1981 and 1983. In an effort to cope with the

crisis, a number of discrete devaluations were applied by mid-1982 and, later on, a crawling peg was reintroduced. Between 1981 and 1988, the real exchange-rate depreciated by 119%. At the same time, the uniform tariff was raised gradually, in stages, up to 35% in September 1984 (with annual averages of 24% in 1984 and 26% in 1985). Starting in March 1985, as the severe shortage of foreign exchange eased, the tariff was gradually lowered once again, until it reached 11% by mid-1991.

Following the crisis, trade policy became more flexible in several respects. The government began to make active use of antidumping measures to protect the economy from unfair trade practices. To this end, the total tariff (the normal compensatory surcharges) was raised to a maximum of 35% — the level to which Chile had committed itself under the terms of GATT in 1979 — on imports that Chile could prove were being dumped. In addition, price bands, intentionally made consistent with international price trends over the medium-term, were set for three main agricultural products: wheat, sugar and oilseeds. Not only did this significantly favor agriculture, but it also constituted a departure from the uniform tariff. With regard to exports, the system of drawbacks was refined, and a simplified system was adopted for minor exports. Under this system, such exports were eligible for a refund of up to 10% of their value so long as total exports of the corresponding item did not exceed a given annual maximum.

C. *Contrasts between the two reform programs.* In sum, Chile has carried out two different trade reform programs: (1) a radical reform in 1974-79 and (2) a moderate reform package, with a mix of liberalization and intervention, in 1985-91. While it is true that the basic characteristics of the country's trade policy — in terms of the dismissal of non-tariff barriers and the adoption of a uniform tariff — have not changed since 1979, it should be remembered that the tariff had, once again, become relatively high by 1984 and was, in addition, accompanied by antidumping measures and the price bands mentioned above. In fact, the tariff level averaged 20% in 1984-89, which was double the average rate for

1979-82. The greatest difference, however, was that, in the first liberalization drive, the exchange rate had appreciated steadily during the second half of the 1970s and into the early 1980s. On the other hand, during the 1980s, the reduction of the tariff — from its maximum level of 35% in September 1984 to 11% by June 1991 (its present level) — was accompanied by a sharp depreciation in real terms (associated with the debt crisis). This development sent positive signals to exporters while managing, at the same time, to far outweigh the slightly negative effect which tariff reduction exerted on the production of import-competing goods. As a result, the production of exportables grew more steadily during the second program. Also, and unlike the first effort at liberalization, it was coupled with a strong upturn in the production of import substitutes, especially from 1984 to the end of the decade.

Since 1989, Chile has had to cope with another influx of external capital. However, whereas a prolonged rise in the currency's value was permitted during the first liberalization program, in keeping with the country's increasingly liberal policy regarding private capital flows, the focus shifted in 1991, and an effort was made to curb appreciation of the peso in order to safeguard the competitive capabilities of the producers of tradeable. Consequently, policy emphasis shifted away from unlimited entry for capital inflows, and an effort has been made to hinder international arbitrage of interest rates. The Central Bank now uses a crawling peg whose point of reference is no longer the dollar but, rather, a basket of currencies. The rate of this basket is allowed to fluctuate within a $\pm 10\%$ band and is subject to a dirty float. As regards capital flows, short-term external credits are subject to a reserve requirement (currently set at 30%) and to a tax. These policies have curbed the real upward thrust in the currency, which began early in 1988, strengthened between January 1991 and late 1992, and then strengthened again in 1994 (Ffrench-Davis, Agosin, and Uthoff, 1995).

If we are to draw any conclusions from Chile's experience, one of them must certainly be that the second reform

program yielded better results than the first (Ffrench-Davis, Leiva and Madrid, 1991). The first was begun during a deep depression (1974-75) and ended in another (1981-82). Both crises were associated with severe external disturbances whose domestic effects were exacerbated by the naïve dogmatism with which the liberalization of the external sector was implemented, and by the confusion that surrounded the program's goals and the policy tools required to achieve them.

During the first trade liberalization program, the sharp reduction in tariffs and the dismantling of quantitative controls appear to have had a greater impact on export growth than the very modest reduction in tariffs of the second program. In the first situation, the point of departure was one in which the large majority of domestic prices of current importables (consumer and intermediate) were not tied to international prices;⁶ consequently, there was enormous room to reduce costs through substituting imported inputs for domestic ones, and there were broad opportunities for bringing about change in relative profitability. The fact remains, however, that because of the recessionary situation in which the reform was implemented, the suddenness with which it was initiated, and the trends exhibited by the exchange-rate and interest rates, the strong export performance was achieved at an extremely high cost, and its dynamism was transmitted too weakly to the rest of the economy. Indeed, *per capita* GDP (as measured by comparing its 1974 and 1981 peaks) grew by less than 1% per year, investment was far below its historical levels, and the economy exhibited a sharp de-industrialization (see Table 3).

In 1984 the Chilean economy began to recover and then went on to sustain growth based on an expansion of exportable supply in nontraditional sectors. Nevertheless, the primary reason for the strong performance turned in by nontraditional exports was not the reduction of the country's tariffs since tariffs were lowered quite moderately and a system of drawbacks was in place for exporters.

During the second liberalization drive, depreciation of the currency was the main reason for Chile's export success, as the

Table 3. Chile: Selected Growth Indicators, 1961-93^a
(Percentages)

	1961-71	1971-74	1974-81	1981-89	1989-93
GDP growth rate	4.7	0.3	2.8	2.5	5.8
Real growth rates total exports ^b	3.4	9.1	7.1	8.5	9.7
Non-copper exports ^b	4.7	8.5	12.8	11.5	11.9
Imports of goods and services ^d	-	-	10.4	0.1	10.0
	1961-70	1971-73	1974-81	1982-89	1990-93
Gross fixed invest- ment/GDP	20.2	15.9	15.7	15.1	20.4
(at 1986 prices) ^c			17.8	18.1	24.2
Manufactures/GDP	25.4	27.2	22.2	20.7	20.9
Exports ^d /GDP	12.0	9.9	21.4	27.0	33.5

Source: Calculation by the authors based on figures from the Central Bank of Chile and from Ffrench-Davis and Muñoz (1990), tables 1,3 and 6.

a - At 1977 prices

b - Exports of goods

c - At constant prices of 1986. Recent revisions of the national accounts makes figures on capital formation noncomparable with previous series. That is why two different series are presented.

d - Exports and imports of goods and services, according to national accounts in 1977 prices.

real exchange rate more than doubled between 1981 and 1988 (ECLAC, 1995: Chapter IV). Foreign direct investment (FDI) also played a significant role in that export performance, particularly in the mining sector.

Two aspects that must be taken into consideration when evaluating Chile's two trade reform programs are the impact they had on the formation of capital and growth of the manufacturing sector. Although formation of gross fixed capital and capital efficiency had increased ever since the recession of the early 1980s ended, the coefficient for fixed investment was still less than 20% of GDP by the beginning of the 1990s, a mark that had been reached as far back as the 1960s (all expressed in 1977 pesos). Inability to surpass that ratio of

investment prevented significant growth from being achieved in the 1974-89 period; indeed, the average, cumulative growth rate for that period was only 2.6% per year (see Table 3).

During the first liberalization program, the economy was subject to rapid de-industrialization, as evidenced by a 5-point drop in manufacturing's share of GDP. Many potentially strong manufacturing enterprises went bankrupt as a consequence of the particular combination of trade, exchange-rate, and interest-rate policies during that period.

The improved performance of trade and manufacturing during the second liberalization notwithstanding, the de-industrialization process set in motion by the first program has never been reversed, and exports are still concentrated in natural-resource-intensive products. However, the share of products with more value added has been expanding from their low base, investment has continued to rise, and the creation of new productive capacity (though only since the early 1990s) has begun to increase at a sustainable pace that now, and only now, is faster than the rate recorded for the 1960s as well.

3. Mexico

Like Chile, Mexico also launched a drastic import liberalization program and, in mid-1985, began a gradual dismantling of its traditional industrial policy. It is important to note that, in contrast to Chile's experiment of the 1970s, Mexico's liberalization effort was both preceded, and followed, by a steep real depreciation of the currency (in 1982-83 and, again, in 1986-87) which gave the manufacturing sector a large foreign-exchange "cushion" for its adjustment (Ten Kate, 1992). These large devaluations were necessary in order to cope with the balance-of-payments and fiscal crises sparked by the suspension of external credit in 1982 and, later, the drop in oil prices in 1986-87.⁷

Before embarking upon its trade liberalization program, Mexico had employed a wide variety of policies to control

imports, stimulate industrial output, and steer the manufacturing sector towards external markets. In addition to a widely dispersed tariff structure having a ceiling rate of 100%, Mexican producers were protected by a system of licenses that applied to 92% of all imports and by the use of official prices for customs valuations, which were, in a fifth of the cases, higher than the actual import prices. Exporters of nontraditional products were given large tax breaks to offset the anti-export bias of trade policy. Furthermore, for quite some time Mexico had successfully been using industrial promotion programs oriented towards import substitution in "strategic sectors" (in some cases in conjunction with export promotion measures). These programs, which provided firms with protection in the domestic market and with tax incentives in exchange for achieving increasingly higher levels of local integration or export targets, had become the country's main industrial policy tool during the "difficult stage" of import substitution (Ros, 1992).

A. *The reform program launched in 1985.* The trade liberalization program began in July 1985 with the elimination of quantitative controls on a large number of tariff positions. These applied primarily to intermediate and capital goods, though some consumer goods were also affected. In the beginning, tariff rates were kept high in order to offset the elimination of direct controls. Then, the following year, Mexico joined the General Agreement on Tariffs and Trade (GATT) in July 1986; its "entry fee" was a commitment to continue to substitute tariffs for direct controls and, later on, to reduce tariff rates. At the same time, an antidumping system was established. In late 1987, together with introduction of what was called the Economic Solidarity Pact, trade reforms were intensified: a large part of the prior permit requirements for consumer goods were discontinued; the remaining official prices were eliminated; and the tariff structure was simplified to involve only five rates, ranging from 0% to 20%, with a production-weighted average of 12% (and an import-weighted average of 6%).

Because Mexico's trade reform program encompassed exports as well, many export permit requirements were eliminated. Those quantitative export restrictions that still remain in effect are made necessary by the existence of either price controls (on some agricultural products) or by agreements, both bilateral and international, principally with regard to coffee, sugar, steel and textiles, which, together, still represented a fourth of its non-oil exports, including the value added by the *maquila* industry). Traditional export subsidies were eliminated as a consequence, at least in part, of bilateral agreements with the United States. The only export incentives in effect are programs that allow duty-free entry for "temporary" imports and exemptions for inputs imported by export firms.

The use of industrial promotion policies has also been reduced substantially, although they continued to exert significant effects on exports. The programs that remain, which continue to place quantitative restrictions on imports, apply primarily to the automobile, microcomputer and pharmaceutical industries.

The thick exchange-rate cushion created by the real devaluations of 1986 and 1987 enabled the government to launch its Economic Solidarity Pact, which included both a freeze on the exchange rate and wage restraints. In fact, the exchange rate began to be used as an anchor for the control of inflation. The nominal exchange rate was frozen in 1988, and, ever since 1989, nominal devaluations have been less than the net rate of inflation (the domestic rate minus the external rate). Since 1987, the real exchange rate has steadily appreciated (see Table 4).

The Economic Solidarity Pact was highly successful in inducing sharp cutbacks in the inflation rate. Along with privatization of the banking system and participation in the Brady Plan, the Pact helped to alter expectations regarding the future of the Mexican economy. In turn, this change also helped to bring in a large volume of foreign capital and led to repatriation of flight capital that had left the country during the debt crisis. This inflow of capital has made it possible to sustain,

Table 4. Mexico: Trade Policy Indicators and Real Exchange Rate, 1981-94
(Percentages)

Year	Domestic production protected by import permits a b	Domestic production protected by official prices a b	Average tariff a b	Number of tariff lines	Maximum tariff	Real exchange rate c (1985=100)
1981	64.0	13.4	22.8	-	-	72
1983	-	-	-	-	-	115
1984	92.2	18.7	23.5	-	-	100
1985	47.1	25.4	28.5	10	100	100
1986	39.8	18.7	24.5	11	50	139
1987	25.4	0.6	11.8	11	40	145
1988	21.3	-	10.2	5	20	118
1989	19.8	-	12.5	3	20	110
1990	17.9	-	12.4	3	20	108
1991	-	-	12.0	3	20	98
1992	-	-	12.0	3	20	91
1993	-	-	12.0	3	20	85
1994	-	-	12.0	3	20	87

Source: Ten Kate (1992), Ros (1992) and ECLAC (1992a and 1994b).

a - The figures shown for 1985 through 1990 refer to December of each year; the figures for 1981 correspond to April 1980 and those given for 1984 correspond to June 1985.

b - Weighted by output.

c - Exchange rate applying to exports (ECLAC, 1992a and 1994b).

and to hasten, the pace of revaluation. Capital inflows have also been stimulated by reforms in other areas of economic policy, such as domestic deregulation, the privatization of a large number of government-owned enterprises, the opening up of the economy to foreign investment, and authorization for foreign mutual funds to invest in the stock market. In order to moderate these capital inflows, some controls on the banks' acceptance of foreign-currency deposits were reinstated in April 1991: e.g., a certain percentage of such funds cannot be loaned out in pesos but must be held as liquid foreign-exchange assets instead, while foreign-currency deposits may not exceed 10% of total deposits.

B. *GDP and export performance.* Although manufacturing exports have achieved high rates of growth and the manufacturing sector's share of GDP has expanded slightly, Mexico's post-reform growth overall has been quite modest, while the deficit on current account has been growing, reaching extremely high levels (see Table 5). From 1985 to 1993, there was no increase at all in *per capita* GDP and investment, despite substantial recovery, remains below historical levels (investment coefficients have ranged from 16% to 21.7% of GDP, as compared to ratios of 22-25% during the 1970s).

The Mexican economy has, however, undergone a major structural change in the form of a sustained increase in non-oil exports (including *maquila* services), which climbed from US\$7 billion in 1980, to US\$16 billion in 1988, and to US\$28 billion in 1993. By the end of the 1980s, manufactures had come to account for 85% of the country's total non-oil exports.

Supporters of across-the board trade liberalization contend that import liberalization is what has made the boom in non-oil exports possible, by giving producers of exportables access to high-quality inputs at international prices and by making it less profitable to produce for the domestic market (thereby encouraging, if indirectly, an export-oriented reallocation of resources). However, the sharp increase in non-oil exports had begun in 1983, before the introduction of trade reforms, thus it is difficult to attribute the expansion entirely to

those reforms. Ros (1992) has estimated that nearly half of the increase in non-oil exports during the 1982-88 period was accounted for by just three sectors (the automobile, computer and *maquila* industries)⁸ which did not benefit from the liberalization measures for one of two reasons: either their imports of inputs were already duty-free (the *maquiladoras*), or those imports that were competitive with their output, or with their imported inputs, remained subject to restrictions under the industrial development programs (such as automobiles and personal computers).

One hypothesis which fits better with actual trends observable in the Mexican economy of the 1980s and early 1990s is that the boom in non-oil exports had more to do, first, with the steep real depreciation of the currency recorded in 1982-83 and 1986-87, and then with the depression that hit the domestic markets, which obliged producers to look for markets outside the country, especially in the United States. Import liberalization may have played a more secondary role. Most of Mexico's new manufacturing exports in the 1980s were produced by industries that were founded during the era of import substitution with relatively moderate new investment. There was no large-scale reallocation of resources to sectors in which Mexico may be supposed to enjoy a comparative advantage (labour-intensive activities oriented primarily towards external markets). Hence, Mexico's successful bid to expand exports was initially made possible largely by its earlier import-substitution effort and by the development programs implemented in strategic sectors (Ros, 1992). During the second half of the 1980s, this process was reinforced and expanded by a more depreciated exchange rate.

More recently, however, as time went by and with Mexico's entry into NAFTA (as well as other trade agreements), new export activities have been developed. Nevertheless, it must be stressed that imports have expanded to a notably larger degree, with a rising deficit and current account (see Table 5).

Table 5. Mexico Selected Growth Indicators, 1980-94

Year	GDP growth rate (%)	Fixed investment GDP (%)	Manufactures/ GDP (US\$ billion)	Deficit on current account	Non-petroleum exports		
					Billions of dollars		As percentages of total exports ^a
					Goods	Maquila services	
1970-1979	6.5	20.2 ^b	22.8	2.6	-	-	85.9
1980	8.3	24.8	22.1	10.8	6.0	0.8	40.0
1985	2.6	19.1	21.4	-0.5	6.9	1.3	35.6
1986	-3.8	16.4	21.0	1.8	9.7	1.3	63.6
1987	1.9	16.1	21.3	-3.7	12.0	1.6	61.8
1988	1.2	16.8	21.7	2.6	14.1	2.3	71.3
1989	3.3	17.3	22.5	4.1	15.0	3.1	69.9
1990	4.4	18.7	22.8	8.4	16.9	3.6	67.4
1991	3.6	19.6	22.9	14.9	18.7	4.1	73.6
1992	2.8	21.1	22.8	24.9	19.2	4.7	74.2
1993	0.6	20.7	22.5	23.5	22.6	5.4	78.1
1994	3.5	21.7	22.5	29.2	27.2	5.8	81.7

Source: ECLAC (1994), Ros (1992) y "Estudio Económico de América Latina y el Caribe, 1994".

a - Share of total merchandise exports plus maquila services accounted for by non-oil merchandise exports plus maquila services.

b - Simple average for the period 1970-1979 in constant 1980 dollars.

4. Bolivia

During the last quarter of 1985, in order to stabilize its economy, overcome hyperinflation, and resume growth, Bolivia initiated an ambitious trade liberalization program which it has been applying ever since (Morales, 1992). Prior to embarking upon this program, Bolivia had a highly dispersed tariff structure, with a maximum rate of 150%; it also had banned some imports and required import permits for others. Its first steps were to establish a single exchange rate, restore complete convertibility, dismantle its quantitative restrictions, and reduce tariff levels. In addition, the capital account was opened up almost entirely. Since then, major real devaluations have been made (see Table 1).⁹

In July 1986, Bolivia simplified its tariff structure greatly by establishing a uniform 20% tariff rate. Early in 1988, the tariff on capital goods was lowered to 10%, with the 20% rate being retained for other products until the end of that year when it was reduced to 17%. In 1990, tariffs were lowered to 5% on capital goods and to 10% for other products, where they have remained to this date. Thus, the Bolivian economy has become one of the most open economies in Latin America and, indeed, the world. In order to stimulate nontraditional exports, a subsidy equivalent to 10% of the value of exports was established. This instrument, which was known as the Tariff Drawback Certificate (CRA), was intended to mitigate the anti-export bias generated by the duties levied on imported inputs that were used in producing exportables. For fiscal reasons and by agreement with the International Monetary Fund (IMF) and the World Bank, the CRA was discontinued in early 1991.

As may be seen in Table 6, Bolivia has been able to put an end to hyperinflation ever since 1986; nevertheless, its rates of GDP growth have been quite modest, especially when compared to those of the 1970s. In the eight years following the steep declines registered in 1985 and 1986, growth of *per capita* GDP has averaged only 1.2% annually. What little economic growth has been achieved was barely enough to bring *per*

Table 6. Bolivia: Selected Economic Indicators, 1970-94
(Percentages)

Year	GDP growth	Gross fix investment/ GDP	Real rate of growth of exports	Total exports (US\$ million)	Non traditional exports ^a (US\$ million)
1970-80	3.9	16.9	-10.5		
1980-84	-1.9	11.5	-28.3	871b	68b
1985	-1.0	12.4	-7.6	673	35
1986	-2.5	13.4	4.5	638	108
1987	2.6	13.7	-0.2	569	106
1988	3.0	13.6	3.7	600	108
1989	3.5	12.6	18.5	822	204
1990	4.7	12.4	20.8	927	292
1991	5.1	12.5	2.3	849	251
1992	1.2	14.1	-2.4	608	206
1993	4.1	14.3	16.8	710	284
1994	4.2	12.9	25.0	985	508

Sources: ECLAC (1994), ECLAC (1995) and "Estudio Económico de América y el Caribe, 1994".

a - Total exports minus zinc, tin, silver, wolframium, antimonium, gold, lead, other minerals, natural gas and other hidrocarbures.

b - Simple average.

capita GDP up to 87% of what it had been before the crisis of the early 1980s. In addition, the investment ratio fell following the reforms. The decline in private gross fixed investment — from 7% of GDP in 1982 to less than 4% in 1990 — was particularly worrisome (Morales, 1992) although it rose again in 1991-93. One positive development, in addition to the sharp drop in inflation, has been the diversification of exports, though these still remain concentrated in mineral and agricultural products.

Nontraditional exports rose steeply from 1988 to 1990, slipped down in 1991-1992, only to move rapidly upward again in 1993-94. The quantum of total exports rose only 74% from 1980 to 1994 (*vis-à-vis* 120% for the region as a whole). Thus, the Bolivian experiment demonstrates that, in a largely undiversified economy with low levels of productivity, reforms aimed at altering market signals in order to align domestic prices with international prices are clearly not sufficient, in and of themselves, to initiate or carry forward a timely process of structural change. Change takes place, but too slowly and with weak, or lagging, pulls on investment and economic growth.

II. LESSONS FROM DYNAMIC ASIAN ECONOMIES

DESPITE their great diversity, the manufactures-exporting economies of Asia share a number of characteristics in common with one another in the area of their respective development policies and strategies (and in their results). This fact alone makes comparison between them and the Latin America countries particularly instructive. The analysis in this section is based on the experiences of the Republic of Korea and Taiwan, which have been engaged in outward-looking industrialization for several decades. Ever since the late 1970s, other Asian economies (Indonesia, Malaysia and Thailand) have undertaken somewhat similar policies and have also reaped positive rewards in terms of promoting growth based on the export of manufactured goods (Agosin, 1992; Noland, 1990; Ariff and Hill, 1989). In all these economies, industrialization started out with an import-substitution model. Without exception, subsequent policies, aimed at giving the economy an outward-looking orientation, have been superimposed upon the existing import-substitution system (Noland, 1990: Chapters 2 and 3). In large part, these economies made the transition to an outward-oriented industrialization model based on the industrial skills and capacities developed earlier.

In general, the strategy employed was that of providing roughly equivalent incentives to producing for export and producing for the domestic market within any given industry, but to offer quite dissimilar incentives (and ones that changed over time) to different industries. In formal terms, the effective exchange rate for exports, which incorporates the effects of all the various incentives offered (tariffs, subsidies, and so on), was more or less equal to the effective exchange rate for import-substitution activities in industry i , but differed substantially between industry i and industry j : $TCE(X_i) \approx TCE(M_i)$; $TCE_i \neq TCE_j$.

Although the level of protection in Korea and Taiwan has decreased considerably over the past few decades, to the point that it now approaches the levels typical of developed countries (Noland, 1990), these economies began their outward-oriented industrialization drives with high protective barriers that were never dismantled for the sake of reorienting the economy towards export.¹⁰ One facet of this process, which an observer cannot help but notice, is the tendency of the state to offer incentives on the one hand and then, at some subsequent time, take them away on the other. In other words, the state has demonstrated a striking ability to institute promotion policies on a temporary basis. Furthermore, all such incentives have traditionally been granted only in exchange for achievement of some specific performance target, usually in the area of exports.

Another highly significant aspect of these practices is the success of the authorities in forestalling a major revaluation, or in preventing the sharp fluctuations in the real exchange rate, such as is commonly seen in the LACs. The presence of tariffs and other substantial trade barriers offers obvious indication that the currencies of these Asian economies were overvalued, but the degree of overvaluation was moderate and was offset, in most cases, by various sorts of export subsidies. In order to control their exchange rate, most of these economies exercised effective control over the control of foreign capital and managed to achieve a satisfactory degree of macroeconomic stability.

The Asian experiences suggest that trade liberalization is not an essential element of export-based industrialization. In

fact, most of these economies have been able to maintain policies that are relatively protectionist in nature and yet to grow outward at the same time. Two basic factors help to account for this phenomenon, which contradicts all conventional trade policy prescriptions. First, in all the successful cases, the authorities have made heavy use of various subsidies for exports in order to offset the anti-export bias implicit in protecting importables; each one of the Asian economies under scrutiny has drawback mechanisms for tariffs and indirect taxes to exporters. The second factor is that incentives have been provided in exchange for achieving specific performance targets and for limited periods of time.

Although all of Asia's fast-growing economies have certain characteristics in common, there are significant differences among them as well, which should be of interest to Latin America. Perhaps the most interesting aspect of the Korean experience has been the differential treatment accorded mature and infant industries (Westphal, 1992). The trade policy applied to mature industries was intended to be neutral, so drawback mechanisms were designed to refund customs duties and indirect taxes to both direct and indirect exporters (the latter being producers that sell inputs to exporters). During the 1960s, these businesses also enjoyed additional incentives, such as access to credit on easy terms, preferential access to import permits, and some reductions in direct taxes.¹¹

The provision of incentives (which were tied to export targets) for government-promoted infant industries was much more aggressive. The principal method employed for this purpose was to award temporary monopolies to selected firms in those industrial sectors that the government wished to promote in return for reaching certain, and specific, export targets. In practice, this meant that promotion of import-substituting activity did double duty as an export-promotion mechanism as well. These firms soon became exporters since they were able to subsidize external sales by means of the substantial profits realized in the domestic market. Perhaps the crucial factor in reaching this goal was that the incentives

employed induced these firms to seek to become internationally competitive from the very beginning. This emphasis enabled them to take rapid advantage of economies of scale and to follow a learn-from-experience strategy.

Another important element was the preferential access to short- and long-term credit on easy terms, which was provided to firms in the selected sectors. In point of fact, the government, by choosing certain sectors, was actually favoring certain conglomerates whose creation it had encouraged. This stimulus to provoke the emergence of agents of production in state-sponsored sectors, together with access to ample credit for those activities at subsidized interest rates, was the state's (successful) way of making up for any shortcomings in the capital markets (Amsden, 1993). The industrial policy was a sequential one: during the 1960s, the state placed its priorities on investments in cement, fertilizers and oil refineries; from the late 1960s into the early 1970s, the emphasis shifted to steel and petrochemicals; then, for most of the 1970s, the focus shifted again: to shipyards, capital goods and consumer durables (including motor vehicles). Finally, in the 1980s, priority was given to electronics, telecommunications and informatics.

The industrial and trade policies applied in the Taiwanese economy have been similar in some ways, particularly with regard to the sequencing of state support for specific firms and sectors: in the 1950s, special assistance was given to the textile, glass, plastics, cement, and consumer electronics industries; in the 1960s, it went to synthetic textiles and steel; in the 1970s, to motor vehicles; since the latter part of the 1970s, the attention has gone to informatics (Wade, 1990a and 1990b: Chapter 4). All of these were industries that were expected to become internationally competitive.

Some of the promotion mechanisms were similar to those used in Korea, including protection of the domestic market, subsidized long-term credit, and tax exemptions. One somewhat different aspect of the Taiwanese experiment, however, was the aggressive use of state enterprises and investment and

the promotion of foreign investment (usually in partnership with national capital) in the sectors chosen for promotion.

As time has passed, the leadership role of the state in putting this industrial strategy into practice has been tempered and taken on a less interventionist cast in both Taiwan and Korea. It is expected that, as a result of the trade reforms now being undertaken, tariff levels and spreads will approach those of industrialized countries (Noland, 1990: 9-11). As the state withdraws from its leadership role in industry, protection gradually takes on the same function in these economies that it performs in industrialized countries, i.e., that of defending the most backward economic sectors (especially agriculture).

III. CRITERIA FOR AN EVALUATION

AN examination of Latin American liberalization efforts and the longer-lived Asian programs yields conclusions that may have an important bearing on the management of economic policy in Latin America. These findings can help to adjust reforms now under way so that they will contribute more efficiently to the countries' efforts to change their production patterns and to speed up growth.

1. The Relationship between Import Liberalization and Export Promotion

Experience has demonstrated that it is highly effective to liberalize imports once a sustained increase in exports and a dynamic transformation of the production apparatus have already been achieved. The cases of the East Asian countries bear witness to this fact (Sachs, 1987). This is the first of the options set forth in the analytical scheme presented earlier (see Section II.1 and Figure 1). Although this course of action is no longer a feasible option for many Latin American countries, the Asian countries' experiences demonstrate the need to take direct steps to boost exports rather than waiting for import liberalization alone to have the desired effect on export performance.

In the majority of liberalization programs underway in Latin America, the option of promoting exports first and liberalizing imports later has already been explicitly ruled out; a liberalization program has already been carried out, and it was done in a country context where creation of productive capacity was far from dynamic. Imports have been liberalized without providing any significant measure of support for exports other than an assumption of spontaneous depreciation of the currency. [This assumption tended to oppose the reality: in Chile during the 1979-82 period, in Mexico from 1988 onwards, and in countries whose liberalization took place in the 1990s.] Moreover, all the countries that have undertaken sweeping reforms have proceeded either to dismantle or cut back on export promotion schemes that had been successful in the past. This suggests that the costs of these liberalization programs will be high, in terms of growth, during the time that transition is being made to a new equilibrium. One constructive question that might be posed at this point is: given the constraints imposed by the path already chosen, how can the overall efficiency of the reforms be enhanced? The suggestions that follow are directed towards achieving that end.

2. Incentives: Selectivity *versus* Neutrality

Neither the mainstream of past experience or the cases discussed here support the hypothesis that, once a country has neutralized its incentives by dismantling protection and discontinuing subsidies, resources will be reallocated spontaneously and costlessly to those sectors in which that country has comparative advantages. Chile's experience attests to the high costs of a radical liberalization drive which did away with selectivity. It is unlikely that the costs of transition will be compensated for by more rapid growth after adjustment has been completed. As the Asian experiences suggest, more gradual, selective policies to liberalize imports, together with greater support for nontraditional exports, might well have enabled the economy to turn in a stronger performance overall.

If the aim is to make efficient changes in production patterns in such a way that the economy will become more open to trade and forge an upgraded position for itself in international markets, then the negative pulls generated by liberalization will not suffice; policies that create positive pulls will also be needed. Obviously, this does not imply a return to the high, indiscriminately protective barriers of the past. In fact, it can be argued that import-substitution policies erred on the side of failing to discriminate enough rather than by being too selective. What is needed is a much greater degree of selectivity, not in the sense of supporting specific activities (which may be difficult to identify) but, rather, of making sure that any deviations from neutrality are few and well chosen.

There are no compelling reasons, either practical or theoretical, for opting for absolute uniformity in the case of tariffs. If most industrial activities are subject to dynamic economies of scale of a more or less diffuse nature, then it can be argued (as it is by Rodrik, 1992) that it is best to benefit broad categories of activities rather than becoming embroiled in the difficult task of trying to "pick winners" through favoring specific industries. Moderation, in terms of the number of tariff levels and brackets, will help to curb abuses. Furthermore, any tariff in excess of the base level should be temporary in nature.

Since the Latin American countries have opted for above-zero tariff levels and, in all cases but Chile, for some degree of differentiation, then roughly equivalent export subsidies are required in order to avoid the anti-export bias of the past. In other words, equivalent incentives should be extended to a given product designed for export as well as for sale in the domestic market.

Export subsidies are necessary, especially if the aim is to promote an efficient form of industrialization in the presence of import duties. One element that is essential if an anti-export bias is to be avoided is the establishment of drawbacks on inputs used in producing exportable goods. Indeed, cases can be found in both Latin America (e.g., Colombia, Costa Rica and Brazil) and Asia where subsidies for nontraditional exports

have been in place for extended periods of time and have yielded positive results. In order to minimize the possibility that such subsidies may be misused, consideration might be given to designing a system whereby subsidies would decrease as exports increase, based on a preestablished, publicly-announced timetable that is not subject to renegotiation.

Selectivity involves a number of different aspects which extend beyond the bounds of trade policy and cannot be examined in detail here. Some of these elements would include the following: (1) ways to give exporters access to pre- and post-shipment commercial credit at international interest rates; (2) measures to supplement the capital market and eliminate its bias against new projects; (3) improvement of the physical and social infrastructure needed to develop the export sector; (4) FDI policies that would facilitate access to new technology and international markets; and (5) adoption of a coherent policy regarding trade negotiations for gaining better access to external markets.

One fact which policymakers should bear in mind as they formulate trade policies for the 1990s is that the international situation has changed substantially since the burgeoning economies of East Asia embarked upon their export-based industrialization processes in the 1960s and 1970s. Today, it would be much more difficult to offer incentives of the magnitude that were granted by the East Asian economies at the time, not only because the present international economic environment is more sluggish and more protectionist (which makes it now more likely, for example, that importing countries would protect themselves against export subsidies by levying countervailing duties), but because the rules and standards governing international trade are now more stringent than formerly. Moreover, if the Uruguay Round of the GATT is brought to a successful conclusion, it is highly probable that the room in which the less-developed countries (LDCs) can subsidize exports will be circumscribed even further.

3. Gradual or Abrupt Liberalization?

The Latin American countries (LACs) that have undertaken trade liberalization in recent years have clearly opted to pursue a rapid course. Thus, the comments that follow here will be directed primarily to those countries that have not yet consolidated their reform process.

It is still too early to evaluate the results of the recent, drastic reform efforts. Be that as it may, the experiences of the East Asian economies, as well as of Colombia from the mid-1960s to 1989 (Ocampo and Villar, 1992) and of Costa Rica during 1983-1990 (Herrera, 1992), appear to suggest the advisability of a gradual approach that permits reconversion of existing industries rather than destruction of a large percentage of the country's installed capacity, as inevitably occurs during a rapidly-applied liberalization initiative, particularly if the exchange rate appreciates.

The transition that Colombia made in the mid-1960s, from an import-substitution model to a pragmatic model that gave equal priority to both import-substitution and export promotion, was an important factor in steering the manufacturing sector towards an increasingly external orientation while avoiding, at the same time, the trauma associated with such drastic liberalization drives as that of Chile in the 1970s. In Costa Rica, tariff reduction took place gradually and in tandem with export incentives and drawback mechanisms. The expansion of nontraditional exports — the most salient feature of Costa Rican development during the 1980s — was generated, in large part, by firms that had been established during the earlier import-substitution phase. In addition, a deliberate effort was made to promote foreign investment in the production of such exportable goods as textiles and electronics.

The adoption of a gradual approach does not mean that all reforms need to be gradual, however. The elimination of the slack in tariffs, the conversion of quantitative restrictions into tariffs ("tariffization"), and the necessary adjustments in the exchange rate can all be done at a single blow. Nevertheless,

subsequent tariff reductions should be phased in gradually so as to keep pace with producers' ability to adapt their production structures to increased competition.

4. The Role of the Exchange Rate

The way in which the exchange rate is handled will undoubtedly play a decisive role in determining the outcome. Averting an exchange-rate lag would seem to be essential to the success of any trade reform whatsoever, regardless of whether it takes the form of a drastic liberalization drive or a gradual, controlled opening of the economy. Once again, the Chilean experiment of 1976-81 (as well as the experiences of other Southern Cone countries during the 1970s) show just how harmful the combined impact of a real appreciation of the currency and a drastic import-liberalization program can be. In contrast, the new adjustment that Chile undertook between 1983 and 1991 was much more successful, and sustainable, than the program implemented during the 1970s because tariff reduction was coupled with a steep real devaluation.

Most liberalization programs that have taken place in Latin America more recently are being implemented in the presence of a sharp real appreciation. In fact, some of the countries in which the import-liberalization process has been most abrupt have also experienced severe lags in their exchange rates. The question of how best to manage the exchange rate so as to bolster the process of changing the production structure is an aspect of economic policy that has not yet been addressed satisfactorily in Latin America.

The experiences of diverse LACs demonstrate that mere application of an exchange-rate policy alone is not an adequate substitute for an effective, comprehensive anti-inflation policy. Except in the short term, when it is used as a means of changing expectations, the exchange-rate anchor for domestic prices has proven to be extremely flimsy, particularly in high-inflation countries. Stabilizing price levels is certainly an essential step in any policy attempt to bring about a permanent change in

relative prices, but this cannot be achieved simply by fixing the nominal exchange rate. On the contrary, the exchange rate is an indispensable tool for changing production patterns while maintaining an external equilibrium. This is one of the messages of the East Asian success experience.

5. Capital Account Liberalization

Another lesson to be derived from examining the differences between the Latin American and Asian experiences is that liberalization of capital flows can jeopardize the achievement of trade liberalization objectives.¹² Financial liberalization has two components — one internal and the other external — that usually go together. Domestic financial liberalization involves, *inter alia*, allowing interest rates to be determined by market forces. External financial liberalization takes the form of a combination of various measures: either permitting nonresidents to deal in the domestic financial market or permitting residents to take out loans in international financial markets; permitting residents to buy foreign exchange in the domestic market and then to invest or spend it abroad; and permitting foreign-currency transactions to be conducted in domestic markets. While domestic financial liberalization strengthens the link between inflation and interest rates, external financial liberalization weakens the link between domestic prices and the exchange rate (Akyüz, 1993). This makes it more difficult to implement a trade liberalization program successfully, for two reasons. *First*, the combination of domestic and external financial liberalization measures makes the exchange-rate more unstable and difficult to control. *Second*, it raises interest rates and makes them more volatile, thereby discouraging productive investment.

The simultaneous liberalization of domestic and external financial dealings poses serious problems for the management of economic policy. Internal liberalization measures usually lead to steep increases in interest rates (both nominal and real) and to wide swings in those rates over a protracted period of

time. When a gap opens up between domestic and international interest rates, and it appears that this is not going to be closed by a depreciation of the currency, then destabilizing capital flows can reach considerable proportions.

Under conditions such as those that prevailed during the second half of the 1970s or early in the 1990s, external financial liberalization makes management of the real exchange rate more difficult (Williamson, 1992). Short-term capital flows, generated by the hope of turning a speculative profit from the differential between international and domestic interest rates, may cause the real exchange rate to become highly unstable and, thus, may hinder the management of this variable, which is an economic policy tool of crucial importance in any attempt to change production patterns.

Moreover, instability in exchange and interest rates tends to give rise to an attitude in which profit-seeking predominates over considerations of productivity and to send confusing signals to the allocators of resources.

Some recent examples can be found in the region of fairly successful approaches to managing speculative capital. One such example is that of Chile, which learned from its experience in the late 1970s. More recently, the adoption of a more pragmatic attitude has made partial protection of the exchange-rate level possible and has helped to make the benefits of trade liberalization more tangible. Colombia has also availed itself of a variety of measures to staunch the short-term capital flows that threatened to trigger a sharp revaluation. Brazil has made some attempts to moderate short-term financial flows as well.

In a number of other LACs, recent efforts at trade liberalization have been accompanied by fairly ambitious initiatives to institute financial liberalization, coupled with heavy capital inflows that have tended to outstrip the ability of the monetary authorities to sterilize those flows. In these countries, the move to dismantle controls on capital and the authorities' inability to regulate capital movements are hindering the efficiency of opening productive activities up to trade.

Hence, the problem that the region faces *vis-à-vis* the balance-of-payment capital account is how to link domestic capital markets up with external capital markets in a way that will minimize unnecessary inefficiencies (currency appreciations that tend to push the markets away from equilibrium) and the destabilizing effects of short-term capital flows, which usually appear when they are not needed and tend to dry up when they are essential to balance-of-payments equilibrium. Therefore, it appears necessary to distinguish between capital flows with long-term production objectives (e.g., foreign direct investment), which are beneficial, and other short-term flows of a purely speculative nature, which need to be discouraged.

IV. CONCLUDING REMARKS

IN conclusion, past experience seems to demonstrate that, together with a rationalization of trade incentives, some degree of selectivity must be exercised with respect to productive development policy. This is what has been done in the fastest-growing economies of East Asia. The problem lies in how to identify the most efficient mechanisms, which will include gradually decreasing incentives, tied to specific export targets, and the reforms needed in the institutional structure of the public sector. The degree of selectivity must actually be greater than during the import-substitution phase, and the criteria on which its administration is based need to be clearly defined. Protection for national production activities and export incentives are part of a policy package aimed at implementing a development strategy that involves changing production patterns. But experience teaches (1) that incentives must be moderate and have definite time limits; (2) that departures from neutrality must be few and carefully chosen; and (3) that the anti-export bias of protection must be counterbalanced with export incentives. It also seems to be more efficient to provide incentives for broad categories of activities, i.e., those that have the greatest chance of providing dynamic benefits that will not be internalized by the market.

Promotion of nontraditional exports appears to be a particularly appropriate sphere for selective trade policies.

The main reasons for implementing such measures are (a) the need to offset the anti-export bias inherent in tariffs; (b) the positive externalities generated by export activity; (c) the shortcomings in capital markets for financing exports; and (d) the economies of scale and opportunities for learning that exporting provides. Without an active policy for promotion of exports, the latter will tend to concentrate in only a few enterprises and in products for which demand is less dynamic and which are more vulnerable in global markets.

One basic prerequisite for fostering the competitiveness of export firms is guaranteeing their access to inputs on competitive terms. These firms should have access to flexible mechanisms for importing inputs, on a temporary basis, to produce exportables. Other alternatives are tariff exemptions or drawbacks, with a minimum of red tape. Such mechanisms could also be applied to indirect exporters (domestic producers of inputs for exporters).

Pioneering export firms could be supported by offering incentives for export of new products or for entry into new markets. One such mechanism is a "simplified drawback," for products whose export level is below a given amount for a specific period. These incentives should be moderate (helping to place competitive, or near-competitive, products in foreign markets), limited in time, and subject to precise performance results in terms of new products or markets.

The public sector can foster improved performance in foreign markets by providing the following: (1) institutional support for export activity, especially in the areas of information, financing and export insurance; (2) management training to encourage businesses to focus on exporting; (3) negotiations to improve access to external markets; and (4) promotion of the exportable supply abroad. Pioneering efforts are also being made in such areas as investing abroad to support export activities, marketing chains, and joint ventures with firms in target markets.

Domestic development of the exportable supply should also be actively supported in order to enable it to adapt to the demands of foreign markets. Timely, up-to-date information on the requirements of export markets, in terms of quality, environmental regulations, standardization, deadlines, and volume would facilitate this task.

Past export-promotion policies often neglected sectors based on natural resources. Recent technological advances in microelectronics, data processing, telecommunications and satellite technologies considerably augment the supply of information on the quality and volume of economically available natural resources. This is one more reason for acquiring and strengthening comparative advantages in nontraditional natural resources that could offer significant economic rents.

To be effective, an export-promotion system must be selective. It is impossible to promote everything indiscriminately. The selection of sectors, and export-promotion decisions in general, should be made in close, systematic cooperation between the public and private sectors. Exporter associations should therefore be strengthened.

Other aspects of selectivity mentioned thus far, and which have not been accorded due attention in recent reform efforts (or, for that matter, some of long standing, such as Chile's), have to do with what the state does to correct market failures hampering investment that is oriented towards changing production patterns. Such action by the state would include policies for supplementing the capital market, attracting foreign investment to new sectors that show promise of offering comparative advantages, upgrading the physical and social infrastructure, as well as applying an effective training program for labor.

In order to open up the production sector in a way that will further a country's development, corrections will have to be made in the more extreme forms of liberalization advocated in recent years. Realistic adjustments will certainly have to be made in the policies being applied by many countries.

Trade policy reforms should be accompanied by greater recognition of the role that the exchange rate plays in bringing about changes in production patterns. It appears to be impossible to steer private sector production activities firmly in the direction of tradeable unless a more favorable, stable exchange rate can be maintained (i.e., one able to withstand the influence of temporary swings in the economy). The region's economic authorities need to pay more attention to the policies needed to achieve this objective, one of which will surely be regulation of short-term capital flows.

One essential condition for a successful liberalization effort is a supportive international environment. Unless protectionism is eradicated from the central countries, liberalization will be greatly weakened as a policy option — not for just a few countries, as in East Asia in the 1960s — but for a broad range of countries that are currently pursuing liberalization initiatives and seeking export-led development.

NOTES

1. In this article we will make use of the distinction drawn by Damill and Keifman (1992) between “opening” and “liberalization.” The former concept applies to a policy package designed to orient an economy towards international markets as part of an export-led process. The latter refers to the dismantling of protective barriers and other government controls as part of an import-led process.

2. This does not mean that the option of import substitution should be discarded. The larger the domestic market in question, the greater the potential scope of import substitution. This is attested to by the fact that the exports of countries such as the United States and Japan represent only 10% and 15%, respectively, of their GDP. What is truly new about the development strategy that is now taking shape is the idea that firms producing goods and services, whether for the domestic or international market, must become increasingly competitive during the learning period. This is achieved, in part, through exposure to outside competition.

3. Up until June 1990, the mainstream opinion was that integration accords should be of a partial, very limited scope, along the lines of the Latin American Integration Association (LAIA)

agreement in force at the time. The predominant view was that trade blocs were inefficient and hindered world trade. President Bush's Enterprise for the Americas changed all that, however, and concerns about trade diversion appeared to have been forgotten.

4. Regarding the case of Chile, see Ffrench-Davis, Agosin, and Uthoff (1995); for a comparative analysis and policy prescriptions see Devlin, Ffrench-Davis and Griffith-Jones (1995).

5. Notice that this was the situation in 1973. However, in the second half of the 1960s, there was a reform in process that included the gradual rationalization of the import regime and the improvement of mechanisms of export promotion. See Ffrench-Davis (1973, Ch. IV).

6. Most capital goods imports were subject to a wide range of tariff exemptions.

7. In Mexico, as in Chile, these devaluations help to balance fiscal accounts, since the earnings from its main export are a major source of tax revenue and have converted the public sector into a net supplier of foreign exchange.

8. In keeping with Ros (1992), here only the value-added by the maquila sector is classified under merchandise exports.

9. The system used by Bolivia for determining its exchange-rate can be characterized as a dirty float.

10. For example, in 1976, more than a decade after its industrialization process was launched, the Republic of Korea had tariffs ranging from 0% to 150%, and for nearly 1,000 tariff items (approximately 40% of all items), the rates were between 30% and 60%. Non-tariff mechanisms and exemptions were also used heavily (Ffrench-Davis, 1986).

11. Incentives other than drawback mechanisms started to disappear in the 1970s, but the levels of protection provided for these sectors on the domestic market were also lowered.

12. Regarding the sequencing of trade and capital-account liberalization measures, see Edwards (1989). On stability and capital movements, see Díaz-Alejandro (1985); Williamson (1992); ECLAC (1995).

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