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Free Trade Agreements and the Credibility of Trade Reforms

The economic success of outward-oriented, pro-trade countries such as South Korea and Taiwan has led other developing countries to attempt trade liberalization. More countries are trying to become integrated into world markets and are dropping old notions that economic development can only be achieved in isolation. Indeed, in the 1980s a number of Latin American countries moved toward more open, liberalized economies. However, of those countries that have attempted trade liberalization, some have achieved great success, while others have failed miserably.

A common thread in unsuccessful trade liberalization attempts is the failure of the domestic government to create a believable trade liberalization policy. If the private sector perceives trade reform as only temporary, investment will not move from the protected import-competing sectors to the more efficient export sectors. In fact, a noncredible liberalization attempt may be worse than no attempt at all.[1] For example, Peru's noncredible trade liberalization attempt in the early 1980s was extremely costly because investors, believing that tariffs would rise again, imported massive quantities of foreign goods and decreased domestic investment.

Most economic analysis of trade liberalization credibility has focused on domestic problems, such as the private sector's difficulty understanding the government's true motives. It is sometimes the case that developing countries show interest in trade reform only because reform is a precondition to assistance from international organizations such as the World Bank and the International Monetary Fund (IMF).

The economic literature, however, has yet to address the role that foreign markets can play in either enhancing or diminishing domestic credibility. The more open foreign markets are, the greater will be the benefits of trade reform, and the greater will be the likelihood of a successful liberalization. On the other hand, if foreign markets are closed, the benefits of trade reform and the probability of a successful liberalization will be smaller.

Indeed, a developing country may eliminate all protection but still fail to entice some investment from the protected import-competing industries to the export industries if investors anticipate a protectionist response in foreign markets. Mexico, for example, is liberalizing trade and increasing incentives to shift resources out of the protected sectors and into the more efficient export sectors. Yet, some producers may be hesitant to increase exports to the United States in fear that exporting too much will trigger a protectionist response from the United States.

In this article, I explore the role of foreign markets in credible trade liberalization, and I argue that credible trade reform in developing countries may require two elements: a credible domestic policy and a credible foreign policy that discourages protection in foreign markets. I also discuss how participation in a multilateral or bilateral free trade agreement can enhance credibility on both the domestic and foreign fronts of trade liberalization. Using the proposal for a free trade

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[1] *For example, see Calvo (1987) and Edwards and van Wijnbergen (1985).*

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agreement between the United States and Mexico as an example, I explain two ways such agreements help maintain open trade. First, a free trade agreement can weaken internal political pressures to reverse liberalization. Second, an agreement can defuse the political trigger mechanism that creates barriers to trade in foreign markets.

Problems with credibility

To be effective, economic policy must be believable. In fact, both theory and evidence suggest that lack of credibility can have very high costs. Consider, for example, the Federal Reserve's policy of stopping the high inflation rate in the late 1970s by reducing money supply growth. Some economists argue that because the private sector at first did not believe the Federal Reserve's resolve to decrease inflation, prices and wages were set too high relative to the future monetary base. As the nominal demand for money exceeded its supply, the lack of liquidity unleashed recessionary forces in the early 1980s. Only when the private sector began to believe the Federal Reserve's commitment to low inflation did the U.S. economy begin to grow again.

Similar problems can result in the case of a trade liberalization when the private sector believes the policy is only temporary. Calvo (1987) shows that significant economic welfare costs can result from temporary trade liberalization. In his analysis, temporary liberalization decreases economic welfare because it works like a tax on future consumption that distorts prices between time periods. The cost of these price distortions is from the misallocation of consumption opportunities between time periods. Edwards and van Wijnbergen (1985) examine a similar problem and show that opening an economy to foreign capital flows, in the absence of a credible trade liberalization policy, can exacerbate preexisting distortions in trade, which, in turn, decrease economic well-being.

The theoretical literature about trade liberalization has addressed the problem of credibility from three angles: the inconsistency between trade reform policies and other government policies, the lack of incentive over time for the government to adhere to trade reform, and the lack of private sector information about the government's incentives.[2]

The first credibility problem arises from the inconsistency between government trade liberalization policies and other macroeconomic policies. An example of this problem is trade reform in a country in which the government tries to keep its exchange rate fixed while it also expands its fiscal deficit and continues rapid money growth. By maintaining the exchange rate fixed while pursuing expansionary fiscal and monetary policies, the government is artificially maintaining a high value of its currency and distorting the price of foreign goods relative to domestic goods. In this case, allowing free trade will eventually lead to a balance of payments crisis as consumers deplete the country's foreign currency reserves to purchase artificially cheap imports. Because the private sector will eventually realize that the government's free trade policies are incompatible with its other macroeconomic policies and that this combination will lead to a crisis, the trade reform will lack credibility. This issue is perhaps one of the more common sources of credibility problems, particularly in Latin America.[3] A possible solution to this problem of inconsistent policies is to first stabilize the macroeconomic environment and then proceed to trade liberalization.

Second, government liberalization policies may be time-inconsistent. A *time-inconsistent policy* is one in which the government, at some date after liberalizing trade, has an incentive to break its promises. For example, Staiger and Tabellini (1987) analyze the case in which a government wants to redistribute income from the rich to the poor.[4] Under this objective, a free trade policy will never be credible because the government will always have the incentive to provide more protection than expected to import-competing

[2] Rodrik (1989).

[3] For example, see Edwards (1989) and Choksi and Papageorgiou (1986).

[4] In formal economic terms, the government's objective is to redistribute income from individuals with a low marginal utility of income to those with a high marginal utility of income.

firms whenever the relative price of imports decreases. When the price of imports falls, the import-competing sector becomes relatively poor; consequently, the government has an incentive to renege on its free trade promise and redistribute income though protection to these sectors. Free trade, then, is not a credible policy because the private sector understands the government's incentive structure.

Creating a credible trade reform that is time-consistent is problematic because it depends on the government's ability to precommit to a particular trade regime. If a government cannot precommit to free trade, it may have to pursue a time-consistent but second-best policy of partial tariff protection. In other words, the government may never be able to create a credible policy committed to complete free trade; it may, however, be able to create a credible policy with less protection.

A third type of credibility problem develops when the private sector does not know enough about the government's true incentives. Whereas the problem of credibility in the previous examples developed when the private sector knew too well the behavior and incentives of the government, here not enough is known. In some circumstances, individuals cannot determine how sincere the government is about its willingness to liberalize. For instance, often governments show interest in free trade only because it is a precondition to foreign assistance from the World Bank, IMF, or another source. Furthermore, the political process may determine that the government committed to free trade today may not be the government in power tomorrow. It may also be the case that individuals cannot determine the relative power of constituent groups that influence future policy.

To overcome the credibility problem caused by inadequate information about the policies of tomorrow's governments, the government may attempt to signal that it intends to reform trade by partaking in behavior that would be too costly for a government only faking reform. Rodrik (1989) demonstrates that overshooting free trade by actually subsidizing imports may achieve this goal, while Aizenman (1991) shows that public investment in the export sectors can signal the government's commitment to trade reform.

The role of foreign markets in a credible trade reform

The economic literature discussed in the previous section has addressed the domestic issues concerning credibility problems but has yet to examine the role that foreign markets can play in either enhancing or diminishing credibility. A fully informed private sector in the liberalizing country may be unwilling to shift investment out of the protected import-competing sectors and into the export sectors for fear that a protectionist response in the foreign countries will hamper access to foreign markets. Even if present trade barriers in foreign markets are low, the belief that they may increase can deter long-term investment commitments in the exports sector. In this case, free trade lacks credibility not because the private sector believes the government's policies will change in the future, but rather because the private sector does not believe foreign markets will remain open.

For example, consider a country that liberalizes its trade sector to eliminate protectionist policies that favor investment in the import-competing sectors and dissuade investment in the export sectors.[5] A firm—a shoe manufacturer, for example—that once only sold its products domestically will discover that its input costs have declined and it can now make a profit selling its products in foreign markets. Suppose also that the firm considers the domestic government's commitment to liberalization to be sincere, but believes that foreign markets may impose tariffs on its shoe exports.[6] The firm may export some shoes, but not enough to maximize profits at the current foreign price of its product. The firm will limit additional long-term capital commitments required to expand capacity if it believes that its current comparative advantage will be eliminated by a

[5] Protection that favored the import-competing industries before liberalization would simultaneously discourage other industries, including exports.

[6] These concerns are not hypothetical. Developed countries have often shown a considerable willingness to protect their industries against import competition. See the box titled "The Rise of Protectionism in Developed Countries."

foreign protectionist response. This situation may be especially important for manufacturing industries that require large, specialized capital investments to increase output, rather than some types of industries that can expand output with small long-term capital investments.

Consequently, even when a trade liberalization policy is credible in terms of being compatible with other macroeconomic policies, time-consistent, and fully known and compatible with government incentives, the threat of a protectionist response in foreign markets reduces credibility.

Free trade agreements and the credibility of trade reform

By limiting the protectionist response in foreign countries, an international free trade agreement can help enhance the credibility of trade reforms. A free trade agreement also reduces the risk of changes in the domestic stance toward trade liberalization by limiting the influence of constituent groups on future government policies. A free trade agreement can enhance credibility by signaling a government's commitment to free trade and by increasing the costs of a future policy reversal.

The sustainability of free trade agreements, as in any legal document or negotiated contract, depends on how comprehensive and well written their terms are, as well as on their ability to resolve future unforeseen conflicts. Unlike most legal contracts, enforcement of these agreements is entirely voluntary, and their credibility does not depend on the objectives and interests of only two parties, but on the relative power of competing interests within two or more subscribing countries. Protectionist measures usually develop not because they are in the best interest of a country, but because the beneficiaries of protection are typically few and individually have much to gain. (*See the box titled "The Rise of Protectionism in Developed Countries."*) Industries will lobby for protection up to the point at which the last dollar spent on lobbying equals the expected additional benefits of increased protection.[7]

According to the political-economy approach to trade policy, the level of protection reflects an equilibrium outcome of competing pro- and antitrade interests. Magee, Brock, and Young (1989, 3), for instance, explain the development of trade policies in the following way: "Policies play the same role in politics as prices play in an economy: both are equilibrating variables that adjust until opposing forces are balanced." According to political-economy models, changes in trade policies can tell us something about the relative power of pro- and antitrade groups. Thus, the negotiation of a free trade agreement (which is like a contest between groups) signals something that may not have been directly observable in the economy, namely an increase in the relative power of protrade interests and the sustainability of free trade. This signal will help increase investors' confidence that free trade will not be temporary.

Unlike the typical piecemeal increase in protection that results from the lobbying activity of individual industries, a free trade agreement may actually imply a general change in the rules of the game in favor of protrade interests. In other words, the agreement may not only reduce tariffs and nontariff barriers to trade but also decrease the benefits of lobbying for protection, enhancing the long-term sustainability of the reform.

A free trade agreement changes the incentives and returns of protectionist lobbying in two basic ways. First, once implemented a free trade agreement will bind together diverse export industries in their opposition to increases in protection. These industries will devote more resources to oppose any potential increase in domestic protection because of the threat of a retaliatory response and possible abrogation of the entire agreement. Usually, it does not pay for any one exporter to lobby against a single protective policy if the costs of such a policy to that firm are relatively small. However, with a free trade agreement, an exporter will have the incentive to lobby actively against any increases in domestic protection in fear that an increase in protection would induce a retaliatory response against its own products from the other members of the agreement.

Second, by making protection more visible, a free trade agreement increases the costs of lobbying for protection. The inclusion of a

[7] *See Krueger (1974).*

mechanism to settle disputes makes hiding and implementing protectionist policies, which lower national income, more difficult. The free trade agreement between the United States and Canada illustrates this effect.

The U.S.–Canada agreement contains two mechanisms to address disputes. The first mechanism requires that each nation inform the other in writing of any proposed or actual change that might affect the agreement. Each country can request discussions on any matter of concern, and any problem that is not resolved within thirty days can be referred to a joint U.S.–Canada trade commission. The second mechanism deals with antidumping and countervailing duty cases. Each country still applies its own antidumping and countervailing statutes, but—at the request of either government—a binational panel can be set up to review the decisions of each country's administrative agencies. In contrast to the dispute-settlement mechanisms of the General Agreement on Tariffs and Trade, problems encountered under the U.S.–Canadian free trade agreement are solved rather quickly. Furthermore, smaller firms are more likely to contest foreign protection because the two governments, not the firm, bear the costs of the appeal process.

Thus, the inclusion in a free trade agreement of adjudication clauses that allow foreign and domestic industries to bring complaints about trade protection to an arbitrage or judicial review committee creates an environment in which protection is more likely to be noticed and more difficult to impose.

In summary, the negotiation of a free trade agreement signals an increase in the relative power of groups that favor free trade and enhances the credibility of trade reform policies. Furthermore, approval of a free trade agreement changes the rules of the protectionist game by altering the reward structure of lobbying. Free trade agreements unite groups that favor free trade in opposition to protectionist lobbying and make protectionist lobbying more likely to be noticed.

Implications for U.S. and Mexican trade

Perhaps from Mexico's point of view, the most significant feature of the proposed North American Free Trade Agreement is that it will lend credibility to Mexico's trade liberalization policy. The agreement can do this in two ways. First, it can weaken domestic political pressures from special interest groups to reverse trade liberalization. Second, it can defuse the political trigger mechanism in the United States that creates barriers to trade.

An executive from a large pulp mill in Chihuahua, Mexico, recently said, "Policies in Mexico have always changed when presidents did, but free trade gives a sense of permanence to the very sound policies of this administration."[8] Indeed, a free trade agreement lends credibility to the Mexican trade reform because it signals an increase in the relative strength of the protrade groups within Mexico and the United States and raises the costs of protectionist lobbying. Currently, tariffs and other barriers to trade between Mexico and the United States are relatively low, but fears of a future increase in trade barriers dissuade investors from making long-term investments in Mexican export-oriented industries. U.S. and Mexican investors will make more long-term commitments if they expect markets to remain open. A credible free trade policy will induce a substantial increase in trade of those products that require long-term capital investments—greater even than what would be indicated simply on the basis of decreases in tariff rates.

Although Mexico's gains from trade are likely to be relatively larger than those of the United States, the type of gains will be similar. Both countries will benefit from a reallocation of resources to industries that reflect each country's comparative advantage. The United States' greatest gain will likely be in the export of services to Mexico, whereas Mexico's greatest gain will likely be in the exports of manufactured goods to the United States.[9] Of course, the terms of the free trade agreement are yet to be seen, but even if the current barriers to trade are not changed, the mere existence of an agreement will improve expectations that the barriers will not increase.

[8] *Rodolfo Figueroa of Grupo Chihuahua, quoted in "Latin Turnaround,"* Wall Street Journal, *May 24, 1991, p. 1.*

[9] *U.S. International Trade Commission (1991).*

As Harberger (1991) notes, "The big message of the [free trade agreement] is that 'this border is open and is going to stay open.'"

Conclusion

In this article, I explored the role of free trade agreements in trade liberalization and argued that credible trade reform in developing countries may require two elements: a credible domestic policy and a credible foreign policy that discourages protection in foreign markets. Participation in multilateral or bilateral free trade agreements can enhance credibility on both the domestic and foreign fronts of trade liberalization. First, a free trade agreement can weaken internal political pressures to reverse liberalization. Second, an agreement can defuse the political trigger mechanism that creates barriers to trade in foreign markets.

The benefits of the proposed free trade agreement between the United States, Canada, and Mexico will derive from not only a decrease in tariff and nontariff barriers but also from a credible commitment that future trade barriers will not be erected. It is the expectation of lasting free trade, in addition to low trade barriers, that will entice long-term investment away from protected import-competing sectors and into the export sectors where a country's comparative advantage lies.

The Rise of Protectionism in Developed Countries

Despite a substantial drop in tariff rates since the creation of the General Agreement on Tariffs and Trade (GATT), protection increased dramatically in the 1980s.[1] Most new protection is based on administrative regulations that are usually implemented through bureaucratic procedures rather than enacted by law.

Administered protection has originated primarily in developed countries, particularly the United States, and is typically directed at imports of manufactured goods. This trend is a consequence of the increased competition in the international market for manufactured goods, where a large number of developing countries have gained a comparative advantage. Increased competition and the ease with which recent protection has been imposed can create problems for developing countries attempting to liberalize trade.

Developed countries initiated more than 1,700 actions of administered protection between 1980 and 1985 (*Table 1*). These actions included countervailing duties, antidumping suits, safeguard actions, and other complaints about unfair trading practices. Under GATT, safeguard actions can be taken when imports threaten or cause serious injury to domestic producers. Antidumping actions are imposed when exports are sold at less than their cost and countervailing duties are levied to counteract the use of subsidies. GATT provided these protective actions to level the playing field; however, the ease with which countries can impose restrictions has led to their use in ways that undermine free trade. Problems arise largely because administered protection is imposed by the country claiming to be harmed, not through international procedures. For example, an antidumping complaint by a U.S. computer firm is investigated by the U.S. government, which determines the U.S. response.

The ability to impose administrative trade restrictions—without a legislative process or an international procedure—offers extraordinary power to vocal domestic constituents in favor of protection. Because administered protection is not usually subject to political debate, its costs often remain hidden. That makes administered protection an especially attractive means for politicians to cater to special interests without protests from other groups harmed by protection.[2]

(Continued on the next page)

[1] GATT was created after World War II as a way to provide the rules and procedures for countries to dismantle trade barriers, particularly tariffs. In practice, GATT provided seven rounds, or meetings, to negotiate international trade policy. An eighth round, the Uruguay round, was added in 1986 but has not yet been concluded.

[2] There are circumstances, although uncommon, in which free trade is not the optimal policy. An example is the case in which a country has monopoly power in world markets. In this instance, a country can use tariffs to extract monopoly rents from the rest of the world. Another case is an industry that is subject to increasing returns to scale or has technological spillovers to other industries. In this case, however, the optimal strategy is to subsidize the industry, not to impose tariffs. Nevertheless, even in such unusual circumstances, free trade is usually the best policy because of the difficulty in determining which industries justify the need for protection, as well as the potential for the political abuse of protection to satisfy special interest groups. See Krugman (1990) for more detailed arguments on this subject.

The Rise of Protectionism in Developed Countries—*Continued*

Protectionism, however, is not limited to administrative regulations. In general, protectionist policies (whether administered or enacted by law) arise because the costs and benefits of lobbying are different for the gainers and losers of free trade. As Pareto (1927), Olson (1965), and others more recently have noted, if the benefits of a protectionist policy are concentrated among a small number of firms and the costs are spread over a large number of consumers, it may not pay for any one consumer to incur the cost of actively opposing such a policy.[3] In other words, the benefits of protection are concentrated, whereas the costs are diffuse.[4]

For example, in 1984 the U.S. Federal Trade Commission estimated that quotas and tariffs on sugar imports cost U.S. consumers $1.266 billion and benefited the sugar industry and government by $783 million.[5] Clearly, this policy was not in the national interest; it represented a national net loss of $483 million. The loss to each consumer, however, was only about $5 a year. That amount is hardly enough to be noticed by most consumers or to motivate them to lobby against sugar protection. To each individual sugar producer, however, the protection represented hundreds of thousands of dollars, which more than compensated for the costs of lobbying for protection.

The current rise of protectionism in developed countries can be seen as a political response by their industries to economic pressures in the world trade system, what Bhagwati (1988, 62) calls the *double squeeze*. The first squeeze has come from Japan and advanced to newly industrialized countries (NICs), such as Taiwan and Hong Kong, which are competing in the market for high-technology manufactured goods. The second squeeze has come from other NICs and developing countries, such as Malaysia and Thailand, which are competing in the labor-intensive manufactured goods market. Since the 1980s, both forces have prompted a structural adjustment in developed countries away from manufacturing and toward other sectors, which, in turn, has touched off strong political pressures to create trade barriers.

(Continued on the next page)

[3] See, for example, Brock and Magee (1978) and Mayer (1984).

[4] Endogenous tariffs may arise as a result of other asymmetries, such as asymmetries in the representation of economic interests within the government organization. See Hillman (1989) or Weck–Hannemann (1990) for a summary of this literature.

[5] Tarr and Morkre (1984). This example is also presented in Krugman and Obstfeld (1988, 189).

The Rise of Protectionism in Developed Countries—*Continued*

Table 1
Number of Administered Protection Cases Initiated, 1980–85

Protection measure	1980	1981	1982	1983	1984	1985	1980–85
Safeguards							
United States[a]	2	6	4	2	6	3	23
Australia	1	0	1	2	0	0	4
Canada	0	1	2	0	0	1	4
EEC*	3	1	1	1	1	—	7
Countervailing duties							
United States[b]	8	10	123	21	51	39	252
Australia	0	0	2	7	6	3	18
Canada	3	0	1	3	2	3	12
EEC	0	1	3	2	1	0	7
Antidumping actions							
United States[c]	22	14	61	47	71	65	280
Australia	62	50	78	87	56	60	393
Canada	25	19	72	36	31	36	219
EEC	25	47	55	36	49	42	254
Other unfair trading practices							
United States[d]	28	19	73	39	33	39	231
Total							
United States	60	49	261	109	161	146	786
Australia	63	50	81	96	62	63	415
Canada	28	20	75	39	33	40	235
EEC	28	49	59	39	51	42	268

*European Economic Community
— Not available.
[a] U.S. Trade Act, Section 201.
[b] U.S. Trade Act, Section 701.
[c] U.S. Trade Act, Section 731.
[d] As defined in the U.S. Trade Act, consist of unfair importing practices (Section 337), unfair trading practices (Section 301), and market disruption (Section 406).

SOURCE: Finger and Nogues (1987), p. 708, Table 1.

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