Domestic Policy No Match for Trade Stance of Central American Countries

The pending U.S. congressional vote on the Central American Free Trade Agreement has increased attention on the trade policies of the participating countries—Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua and the Dominican Republic. (The agreement is known as DR-CAFTA since the Dominican Republic's inclusion in August 2004.)

Entering into regional trade agreements has well-documented positive effects on participating nations, rich or poor, even though the impact on the United States would be lessened by the small market sizes of the DR-CAFTA countries. From the DR-CAFTA countries' perspective, the agreement's impact could be large.[1] Even the most populous of these nations, Guatemala, has less than half as many people as the state of Texas. Moreover, despite what the habitual detractors of trade liberalization claim, there is much evidence that trade openings typically have positive effects on income per capita—generally including that of the poorest fifth of the population, even in developing countries.[2]

Trade Liberalization vs. Domestic Market Orientation

While future trade liberalization is important, the current disposition of the DR-CAFTA countries toward free trade is not new. A good deal of trade liberalization has already taken place in these countries, so future opening is simply more of a good thing.

The past trade openings raise more general questions about market-oriented changes in policies in the DR-CAFTA countries. Have these countries operated consistently with market competition overall? Have they—as with trade—gotten any better at it? I use an index to show that, on average, changes in trade policy in the DR-CAFTA countries have followed a different trajectory than DR-CAFTA market-oriented policies in general, with the trade policy indicators demonstrating more movement toward market orientation. Although the nontrade indicators revealed more market openness to begin with, market openness in the trade sector has long since become greater.

Chart 1 compares three indicators of market orientation constructed from the Heritage Foundation's Index of Economic Freedom. The first, degree of trade openness, is simply the Heritage Foundation's measure without further adornment. The second, domestic market orientation, reflects the Heritage Foundation results about market openness in eight nontrade domestic policy categories: fiscal policy and fiscal balance, government intervention in the economy, monetary policy (with its inflationary implications), banking policy, flexibility of wages and prices, protection of property rights, transparency and simplicity of regulation, and importance of the informal sector versus the formal taxpaying sector.

These different indicators may not always be easy to compare, but they are all scaled to fit the same range of movement. In all cases, a value near 5 means not at all market friendly (such as Honduran monetary policy or Nicaraguan trade policy in the late 1990s), while a value near 1 means very market oriented (such as Salvadoran monetary policy and government intervention now).

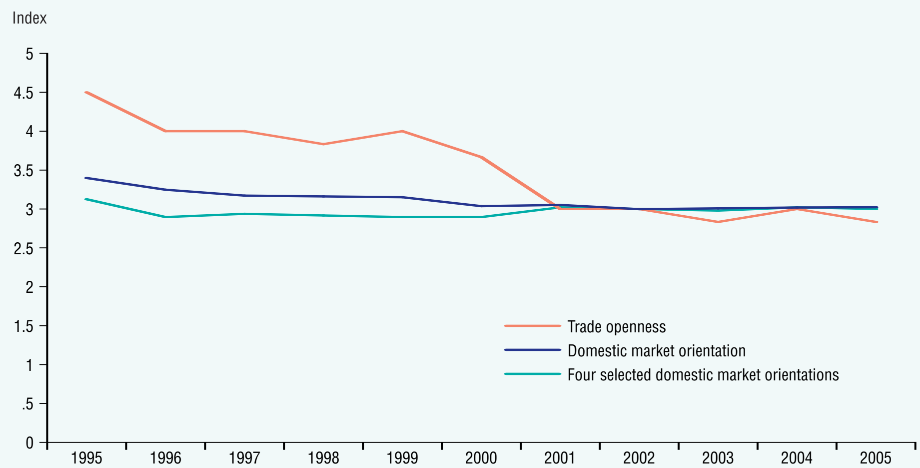
Finally, I narrow the focus of domestic market orientation to a subset of just four variables because I think they deserve more attention than the others. The final four are government intervention in the economy, protection of property rights, degree of regulation in the economy, and wage and price flexibility. Once again, a lower index value represents a greater disposition to let markets work, while a high number means the opposite.

As Chart 1 shows, the DR-CAFTA countries on average have experienced a marked decline in trade protectionism. The value of this index falls from 4.5 (high to very high trade protectionism) in 1995 to 2.8 (low to moderate) in 2005. In contrast, the measure of domestic mar-

Chart 1

Trade Openness vs. Domestic Market Orientation in DR-CAFTA Countries

(Lower values = more market orientation)

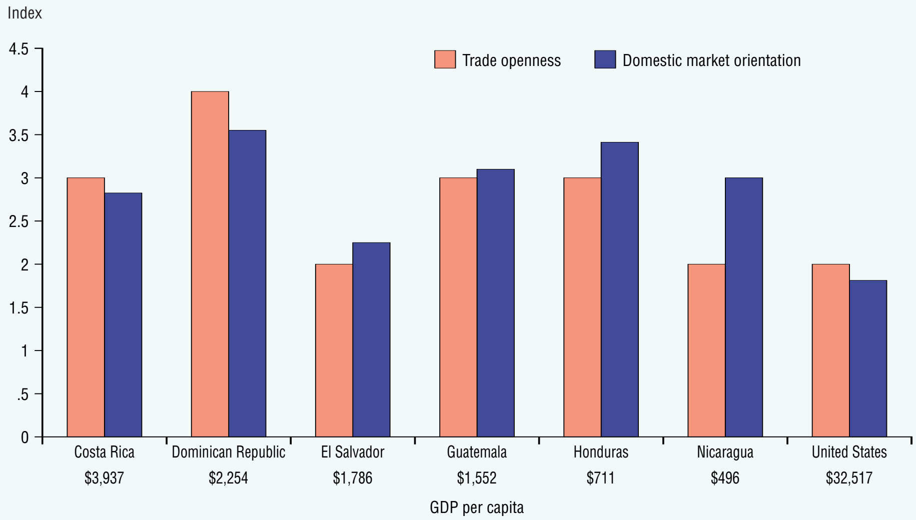


SOURCES: Index of Economic Freedom, The Heritage Foundation, various years; author's calculations.

Chart 2

A Closer Look at Trade Openness and Market Orientation

(Lower values = more market orientation)



SOURCES: Index of Economic Freedom, The Heritage Foundation, 2005; author's calculations.

ket orientation (the eight measures noted above) falls from 3.4 in 1995 to 3 in 2005.

To the extent that it is fair to compare one indicator with another, movements of nontrade indicators in the direction of a market-based economy were much smaller than market-oriented movements in the trade indicators. Nontrade indicators showed more market orientation in the early going than the trade indicator did. In 2001, the falling (improving) trade index caught up with the domestic index and has remained below it for most of the time since.

The relation between the trade index and the four selected domestic market openness measures is similar, except that the line for the four variables starts at a lower (more market-oriented policy) value than that for the eight variables. Note that the final values for both domestic market orientation measures are the same.

Because the trade openness line is above both domestic market orientation lines in 1995 and below them in 2005, we know that—despite the virtues of future trade opening—the domestic market measures have farther to go before they get where market-oriented voters want them. While trade is a legitimate focus for policymaker attention, so are the other indicators—and perhaps a little more so these days.

Certainly it is not true that market orientation automatically means more growth than market closure. Many factors working jointly determine economic expansion. The Heritage Foundation's measures include nothing about educational quality, for example, or managerial skills. But when other things are equal, market orientation seems to make a difference.

Differences Across DR-CAFTA Countries

So far I have discussed how trade openness has moved compared with other measures of market openness for the DR-CAFTA countries overall. With six countries of varied sizes and incomes, we might expect that summary statistics hide a lot of differences across countries. Chart 2 offers a current snapshot of the connection between trade policy and domestic market policy in each of the six DR-CAFTA countries and in the United States. Lower values signify greater market openness.

A striking detail is the tie between GDP per capita and this trade–market policy connection and what it suggests about the relation between economic development and openness. In the two richest DR-CAFTA countries, Costa Rica and the Dominican Republic, the openness of the domestic market category is greater than (shows a lower value than) that of the trade sector.

However, it must be noted that neither trade nor nontrade policy is very market oriented in the Dominican Republic. In fact, the Dominican Republic has both less open trade and less market-oriented domestic policy by the Heritage Foundation's indices than any of the other five Central American countries. The relation between the two types of openness suggests the Dominicans are more interested in nontrade domestic market orientation than in trade policy. This is a trait they share only with the Costa Ricans and, interestingly, the United States—the three countries with the highest GDP per capita among the DR-CAFTA participants. The four poorer Central American countries all exhibit more trade policy orientation than nontrade market orientation.

In and of themselves, these measures do not prove that income is higher because of the market-related orientation of these institutions or that higher income has motivated the development of market-related institutions. But there is much to suggest that the causality runs both ways. The contrast of richer with poorer DR-CAFTA countries is striking in any case.

Moreover, while all four of the poorer countries have less domestic market openness than trade openness, the two richest of those four (El Salvador and Guatemala) have domestic openness levels closer to their trade openness ratings than the two poorest (Honduras and Nicaragua). This again suggests a positive relation between GDP per capita and market openness in policy other than trade, regardless of the direction of causality.

Perhaps as interesting as any detail of this chart is the relation of U.S. trade policy openness to that of the various DR-CAFTA countries in comparison with the relative measure of domestic market openness. Note that the Heritage Foundation measures are not very refined or detailed. A scale of 1 to 5 precludes many opportunities for measurement subtlety. However, it is instructive that El Salvador, Nicaragua and the United States appear in the broad trade openness category of 2; the measure of greatest trade openness is 1. However, the United States has much to recommend against it in agricultural trade protectionism as well as in other historical cate-

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gories of commerce, such as the garment trade. It should be noted that some of the same protectionisms that limit the United States to a 2 have found their way into the agreement that is hoped to be forthcoming with the DR-CAFTA countries.

In contrast, none of the DR-CAFTA countries have policies that facilitate domestic market orientation to the degree the United States has. In the eightfold measure of domestic market orientation, the Heritage Foundation's measure averages 1.8 for the United States, compared with 3.0 for DR-CAFTA countries overall. Clearly, the richest DR-CAFTA nations do not always show the greatest domestic market orientation (Costa Rica at 2.8 vs. Dominican Republic at 3.6), but a large and significant technical literature on such orientation suggests that its growth prospects deserve attention.[3] Also, even though the direction of causality may run both from higher income to more market orientation and vice versa, the domestic market orientation not only of relatively high-growth industrial countries such as the United States (1.8) and the UK (1.8) but also of Asian tigers such as Taiwan (2.3) and Korea (2.6) suggests a basis for growth, despite some glaring exceptions (China, 3.3).

Conclusion

If Congress ratifies the trade agreement with the DR-CAFTA countries, there is much to suggest that both sides will receive growth benefits. But the DR-CAFTA countries have already pursued substantial trade liberalization over the past decade. In some ways, the new agreement is just frosting on the cake. Indeed, for the average DR-CAFTA country, a stickier problem seems to be somewhat less market-directed orientation of policies outside the trade sector. Up to now, market-directed reforms in the nontrade policy area have been smaller on average than those in the trade policy area.

It is clear that the DR-CAFTA countries are working toward more trade liberalization. It will be important to see if the market orientation revealed in anticipated further reductions in trade restrictions—and the improvements in dispute settlement and other factors to facilitate international commerce—will ultimately find expression in purely domestic avenues as well.

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Note

1 Note, however, that the DR-CAFTA–U.S. agreement includes significant trade protectionism. DR-CAFTA sugar exports will reflect heavy U.S. trade restrictions. The agreement's provisions for the garment trade reflect U.S.-imposed content rules that make costs higher for U.S. consumers.

2 An excellent overview of the relationships among trade policy, economic growth and poverty is found in "Trade Liberalization and Poverty: The Evidence So Far," by L. Alan Winters, Neil McCulloch and Andrew McKay, *Journal of Economic Literature*, vol. 42, March 2002, pp. 72–115.

3 See, for example, *Barriers to Riches*, by Stephen L. Parente and Edward C. Prescott, Cambridge: MIT Press, 2000.

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