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TRADE REFORMS IN LATIN AMERICA

Issues for Country Studies



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1. New attitudes towards trade reform

Trade policy reform, like any other major reform in public policy, involve a complex combination of controversial economic issues with institutional peculiarities and political economy considerations that makes international comparisons a difficult task. Notwithstanding there has been substantial work on cross-country comparative analysis of trade policy, the pioneers being the large research projects conducted by the OECD and the NBER in the seventies, both of which generating book length country studies and synthesis volumes¹. Both projects, by and large, stemmed from the desire to apply new theoretical developments - notably in the area of measurement of static costs of protection, e. g. effective rate of protection - so as to make a case for trade liberalization in developing countries. Yet, despite these studies' impact in academia and on the culture of multilateral institutions, both projects failed to be influential as far as trade policies in developing countries were concerned. Apparently, the size of static costs of protection, impressive as they might seem in some cases, appeared a secondary consideration in countries engaged in major efforts to advance industrialization.

More recently, a multi country research project on trade liberalization was conducted under the auspices of the World Bank, from which there

¹ The OECD project resulted in studies on Brazil (Bergman), Mexico (King), Pakistan (Lewis), India (Bhagwati & Desai), Philippines and Taiwan (Ho-Ruan, Power & Sical) and a synthesis volume authored by Little, Scitovsky and Scott (1970). The NBER project had books on Colombia (Diaz-Alejandro), India (Bhagwati & Srinivasan), Korea (Frank, Kim & Westphal), Turkey (Krueger), Ghana (Clark-Leith), Israel (Michaelly), Egypt (Tansen & Nashushibi), Philippines (Baldwin) and Chile (Behrman), and two synthesis volumes by Bhagwati (1978) and Krueger (1978).

resulted 19 country studies and a synthesis volume¹. The focus was restricted to liberalization episodes, 36 of which taking place in the sample countries in the period 1951-82. The questions asked, as stated in very outset, were related to "how", and not on "whether"², and in this connection the themes were speed and intensity, circumstances, targeting, balance of payments behavior and macroeconomic performance. Like the earlier studies, this project has very explicit the case for trade liberalization, which, as of late, has become an important conditionality item in the Bank's policy based lending, whose importance has grown significantly in recent years.

The experience of the 1980s could recast Latin American assessment on the implications of protectionist trade regimes and willingness to liberalize through for reasons different from the once emphasized inclusive studies and advocated by multilateral organizations. There has been a growing perception in Latin America that the trade and industrial policy framework has become detrimental to the attainment of dynamic efficiency and that the handicap it imposes on international competitiveness is more serious now than ever before. This new perception appears to derive first from the influence, in the normative analysis of trade and industrialization, of the growing number of theoretical contributions emphasizing the importance of factors such as learning and economies of scale as the basis for comparative advantage in manufacturing, which supplied some academic legitimacy to active trade and industrial policies in NICs, but resulted also in considerably increasing the awareness of the quality and the dangers of such

¹ The countries involved were Argentina, Chile, Uruguay, Korea, Philippines, Singapore, Israel, Yugoslavia, Brazil, Colombia, Peru, Indonesia, Pakistan, Sri Lanka, New Zealand, Spain and Turkey. The synthesis volume is authored by Michaely, Papageorgiou & Choksi (1991).

² Michaely, Papageorgiou & Choksi (1991, p. 1).

policies¹.

In addition, perceived development challenges have definitely changed, as the advance of industrialization redefined the nature of the questions asked about strategic choices regarding industrialization. The policy problem today is no longer how to save foreign exchange by protecting the establishment of industries to produce for the domestic market at not too unreasonably large cost differentials relative to world prices in the not too distant future. The great challenge today is how to reform the existing policy framework built to answer the former problem so as to overcome its obvious inadequacies to generate the managerial dynamism required to meet the challenges posed by the world's fast changing technological trends and the continuous need of export upgrading by middle-income manufactured exporters².

Besides, the task of restoring sustained growth requires lifting a potential foreign exchange constraint imposed by the debt burden, restoring domestic savings from its very depressed levels, and redressing government financial balance in a context of rising demands for greater distributive equity and the provision of social overhead services³. Now, the only way to simultaneously meet these apparently inconsistent targets is to increase productivity growth, as it would prevent both the erosion of manufactured exports competitiveness as well as the shift in income distribution towards wages and a consequent fall in the savings ratio⁴.

¹ For a discussion of the implications of "new theories" as far as broader debates on trade policy are concerned see Krugman (1989) and also *The Economist* (1990, pp. 19-25).

² See Fritsch & Franco (1991) for an extended discussion.

³ See CEPAL (1990).

⁴ For an elaboration of the argument, see Fritsch & Franco (forthcoming)

These new perceptions placed the concern with efficiency considerations at the centre of the stage and also sharpened political perceptions of the very high costs (and the very uncertain public benefits) of the large subsidies and, especially, tax expenditures, associated with traditional industrial and export promotion policies as well as the allocative distortions related to excessive and rent creating government regulation and the operation of the vast network of industrial public enterprises. This slow move of the opinion towards deregulation especially in the sphere of trade and industrial policy - was also undoubtedly reinforced by the almost permanent pressure from some OECD governments and multilateral organizations in this same direction. The actions of the IMF and especially The World Bank, as well as the policy prescriptions embodied in government initiatives as, for example, the Baker Plan, had certainly played a role in inducing Latin American countries towards liberalization in the late 1980s, as the leverage of such institutions *vis-à-vis* some debtor governments was very strong.

These new perceptions and prescriptions have turned into action in many Latin American countries currently undertaking programs of trade liberalization - Mexico, Venezuela, Brazil, Argentina, Costa Rica, Jamaica, and Colombia, in addition to Chile and Bolivia, many of which now with trade regimes less restrictive than before the debt crisis¹. Interestingly, there is no record of such a collective move towards freer trade in Latin America in a moment in which the balance of payments outlook persists threatened by the debt overhang and macroeconomic instability is of very significant proportions in some countries. If one bears in mind that "common sense

¹ See Laird & Bogues (1989).

would suggest that the conventional benefits of liberalization become muted, if not completely offset, under conditions of macroeconomic instability characterized by high and variable inflation on the one hand, and fiscal and balance of payments crisis on the other¹ - a point the World Bank study does not seem to support - one cannot fail to be impressed by the extent to which the new perceptions alluded above, or the strength of multilateral agencies, have become dominant in Latin America.

In view of the above, one should be concerned about whether these new influences might not carry Latin American economies too far on the liberal side, given the uncertainties surrounding the design and the effects of liberalization, its macroeconomic conditions and domestic resistances to change.

2. Uncertainties regarding trade reform

It is important to have in mind that the strength of convictions and policy commitments to trade reforms is not sustained by a clear rationale as to the mechanisms connecting freer trade with dynamic efficiency, productivity growth and better overall macroeconomic performance. By and large, there is a feeling that greater involvement with the world industrial economy is very likely to be rewarding, which is broadly confirmed by the experience of countries said to be more "outward oriented" in recent years. Yet, the latter categorization is usually defined by variables such as trade shares and the structure of incentives and it is by no means a synonymous of absence of trade intervention. As recently put, "There is much to be said in

¹ Rodrik (1990a, p. 2).

favor of outward-oriented development strategies relative to inward-oriented — but general observations such as these do not really justify the equation of outward orientation with market liberalization¹. A country might thus become more export oriented and do well macroeconomically and maintain a very restrictive regime regarding imports. Greater outward orientation, in conclusion, does not necessarily imply a full fledged free market attitude and to strike a balance is no easy task.

No doubt, the lack of a clear understanding as to the nature of links between liberalization and dynamic efficiency has led to shortcomings and some improvisation as regards the design of such reforms. Indeed, the relation between the trade regime and dynamic efficiency, or technological dynamism, has been a hotly debated topic as of late. A recent and authoritative survey would observe in this regard that there is no clear cut confirmation of the hypothesis that countries with an external orientation benefit from greater growth in technical efficiency in the component sectors of manufacturing; combined with the relatively small static costs of protection, this finding leaves those with a predilection towards a neutral regime in a quandary². In fact, it has been noted that, essentially, the issue has much to do with the relation between market structure and innovation, with respect to which controversy has been going on for quite some time³. Dynamic efficiency and productivity growth are related to market structure through many complex mechanisms and also to government regulation of manufacturing activity which, heavy as it was in the formative years of Latin American industry, has been crucial to shape many structural features

¹ Sachs (1987, pp. 292-3).

² Pack (1986, p. 38).

³ See Fritsch & Franco (1990).

as manufacturing the precise nature of these interrelationships should be better understood to allow a decision of trade liberalization that makes the most of available opportunities.

Through the years in Latin America, regulation of manufacturing activity in general and the trade regime in particular have been affected by many factors. Balance of payments considerations have traditionally been the crucial motivation to import repression leading also to anti-export biases when opportunities open in the international economy are perceived as unattractive. Industrial policy considerations have also been important in generating targeted protection or incentives in many sectors and, last but not the least, political economy factors have also been important to define the nature and extent of the protectionist apparatus and the structure of incentives. National experiences tend to differ in many important ways as to the relative importance of these three factors in the shaping of particular policies implemented and institutions created. The research on policy reform should start by recuperating the process by which practices, culture, institutions and trade policy instruments developed in different countries.

Once one has an overview of institutional realities and historical factors related to existing systems of protection and export incentives the next step is to discuss options available along with their implications as far as trade reform is concerned. Since the classic OECD and NBER studies the conventional recipe for trade liberalization has been very simply stated as a move towards "Phase V", or "level 20", as non-tariff barriers and exchange controls are replaced by "equivalent" tariffs which are then brought down in a velocity and with a targeted content that may vary from case to case. The method is simple and direct and the difficulties found for the implementation, as seen by liberalizers, of a Pareto improving measure tend

should be due to the political system's incapacity to carry out its voters or to those involved in the relevant decision spheres. There are many models for the determination of protection most of which heavily dependent of a particular type of decision making as regards trade reform¹. More importantly, however, is the fact that trade liberalization, as observed in the recent World Bank study on liberalizations, "has often been undertaken upon a radical change in the political regime". Indeed, fourteen of the thirty six liberalization episodes identified in the study were conducted by newly installed authoritarian governments of free market persuasion².

If, however, a drastic orthodox liberalization is not to be pursued and if an authoritarian regime with full autonomy is not in place, the choices to be exercised include complex definitions as to industrial policy priorities, institutions, instruments and practices, having in mind the mechanisms through which the new policies should enhance dynamic efficiency and the political system within which the issues would have to be discussed and coalitions formed. The profile of manufacturing, the evidence on the relationship between market structure, regulation and technological dynamism, as well as the likely future nature of structural adjustment efforts involved are all crucial elements in the definition of country specific trade reforms.

The consideration of the political arena in which trade reforms are going to be discussed involves issues regarding the political process and

¹ For a review of neo-classical models of the political economy of protection see Baldwin (1984).

² Michaely et al. (1991, pp. 43-44).

more particularly the modes of organization and representation of economic interests before the relevant decision spheres in the domain of trade policies. A number of factors could be related in this connection¹. Historical tradition may have a very concrete bearing on ideas and attitudes about relations with the international economy, there being a varying degree of concern with sovereignty in different countries. Nationalism, in addition, tend to find sophisticated mechanisms of expression in schools of economic thought whose prestige and penetration is also variable across countries. The organization and stability of the political system is also a crucial factor in determining the viability of trade reforms. Very often in this domain blocking coalitions may be formed in view of the fact that producers are generally much better organized than consumers, which creates an asymmetry in political representation that results in a protectionist bias, or an inertia to reforms, both as regards design and implementation of reforms. Blocking coalitions, however, are often unable to implement their positive alternatives given political deadlocks, or the fact that requirements to change are often harder than the ones to preclude change. In this connection, it matters the "depth" of the trade regime in the sense of whether its modification depends on discretionarily taken administrative measures or, on the other extreme, on constitutional reform passed in Congress. This certainly makes a difference as regards the relative strength of blocking and reformist coalitions in the area of trade policy reform. Deadlocks might be by-passed if the executive accumulates political capital necessary to enforce reforms as part of its wide political project, or might be, on the other extreme, enhanced if political developments lead to the weakening of the executive. The circumstance

¹ An interesting practical guide is supplied by Whitehead (1990).

might be quite varied and from this point onwards the analysis cannot help being country specific.

3. Macroeconomic Conditionants of Trade Reform

Balance of payments difficulties and associated macroeconomic instability have been the key factors affecting trade regimes in Latin America, and the experience of the early eighties has been no exception in this respect. Yet, national responses in terms of policy choices and institution building associated with import repression and export promotion display important variations. A crucial issue bridging macroeconomic considerations and the trade regime is exchange rate management. The willingness to let real exchange rates move as to induce external adjustment is certainly variable across countries and over time for the same country, and this may be explained to some degree by domestic "elasticity pessimism" - i. e. presumably unfavourable elasticities for imports' demand and exports' supply - and also by perceptions as to opportunities available in the international economy, i. e. demand for exports. It may be also explained, and possibly to a larger extent, by the perverse distributive implications of real devaluations. The latter can be easily expressed if we write the following identity:

$$P = m.(b.w + c.e)$$

where P stands for output price, m represents the mark-up factor or the profit margin, b and c are the labor and foreign input requirements per unit of output, w and e are the nominal wage and the exchange rate and P^* the price of the imported input. It is readily verifiable that, for $\alpha_w = (1/b.m)$ and

$\alpha_1 = (c/h)$ we are a linear inverse relation between the real wage and the real exchange rate, for a given mark-up level:

$$\omega = \alpha_p - \alpha_1 \cdot \epsilon$$

where ω stands for the real wage and ϵ for the real exchange rate. It is not difficult to start from these relations and to build a story of real wage resistance leading to distributive conflicts and inflation as one tends to push the real exchange rate towards devaluation. Latin American countries certainly differ in the extent to which wage indexation is adopted, union's strength and militancy¹, and mark-ups rigidity as consequence of non-contestability of markets, and also as regard the size of the non-tradable sector. Regarding the latter, the larger it tends to be, the larger the required real exchange rate change for a given effort of external adjustment, and the larger inflation tends to be. This is more or less confirmed by experience, as larger Latin American countries tend to be more prone to chronic inflation². Countries vary, therefore, in the extent to which inflation is generated as a result of the attempt to change real exchange rates and tolerance of inflation is certainly an important political economy issue that defines the extent to which a given country may effect balance of payments adjustment through expenditure switching measures³.

¹ Which quite obviously governs the tolerance of unemployment, or of expenditure reducing measures.

² This is easily shown using the stylized version of the "Scandinavian model" of inflation developed in Canavese (1982, p. 525).

³ Explanations of inflation derived from the need of changing key relative prices that are resisted by social groups affected stemmed basically from the original "structuralist" theories. It is clearly shown, for example, in Canavese (1982) and also in Modigliani & Padoa-Schioppa (1978) that the inconsistency between workers' targets and the requirements of external balance may generate chronic inflation. For a recent application of these models to the Latin American experience see Franco (1991).

The connection between inflation and adjustment efforts often produces a coincidence between the need to liberalize and the need to implement stabilization, and the latter, to say the least, reduces the degrees of freedom to be spared in liberalization programs. If stabilization policies imply targeting exchange rates, depressing activity levels and investment, and restricting the fiscal stance, chances of success of liberalization are surely reduced. Exchange rate depreciation often lags behind inflation - or at least devaluations are avoided - in stabilization programs, which magnifies the balance of payments effect of reduced protection and confuses the speed of tariff reductions. Restrictive fiscal policy reduces the scope for targeted incentives and low levels of investment turns structural adjustment more painful, as there is little of expanding sectors to absorb resources spilled from contracting ones.

Stabilization and liberalization are dependent upon each other in many ways. If stabilization fails, or happens to be protracted and painful, the associated deterioration of the macroeconomic environment results in confusing more and more the prospects of liberalization. The success of the latter, on the other hand, may help building credibility for stabilization as it would mark a "break from economic policies of the past"¹ and enhance ~~governmental~~ *governmental*. Failure in liberalization, or if it is seen as inconsistent and temporary, may be, in contrast, a disaster that may add quite considerably to macroeconomic instability, and this risk may well be enough to prevent the launching of liberalization².

¹ Rodrik (1990a, p. 13).

² Rodrik (1990b).

4. The formation and typology of trade regimes

Once it is possible to frame different countries' macroeconomic experiences in the trade-offs alluded above and the relevant political economy issues identified, one is in a position to assess the extent to which external imbalances have to be solved by commercial policy. Within this domain a vast array of possibilities can be seen in practice. Price measures - tariffs *cum* subsidies, and multiple exchange rates - are extensively used as measures to create sectoral biases and moderate the impact of a full fledged change in relative prices determined by a real devaluation. Quantitative restrictions (QRs) are also pervasive in Latin America, and they assume many forms. They might be "border" measures enforced by customs authority, such as prohibitions (and their exceptions), quotas, ceilings and "similarity" examinations, and might be "non-border" measures, generally enforced by other public bodies, such as local content requirements (demanded in public procurement and by official banks as conditionality for subsidized financing, for example) or counterparts (requirements for advanced deposits or external financing for importers). The distinction is relevant as it matters for pressures exercised under the GATT, which is more concerned with "border" measures.

Generally, import restrictions, and more generally, trade regimes, are classified according to the extent they employ price measures, or their restrictionist content, this being the spirit of the fivefold classification provided by Bhagwati (1978)¹ and the subjective index of liberalization - ranging from 1 (the least) to 20 (the most liberal) - provided in the World Bank's 1991 study. Static efficiency considerations apart, whether the

¹ Bhagwati (1978, pp. 56-62).

system is more "market-based", i. e. dependent on prices, or discretionarily managed is crucial to make transparent the several ways through which protection is targeted, which is important to clarify in the political arena the interests in the preservation or change of existing regimes. By and large, the appeal for transparency seems to be the main motivation to a move towards tariff based systems, and one that changes the political framework within which protection is discussed.

From the point of view of the management of trade regimes it is interesting to distinguish them by the degree of bureaucratic centralization. "Border" QRs and price measures tend to be centralized on the customs authority, but their application might become decentralized, or sectorialized, when the extent to which targeted industrial policies are implemented, or the amount of sectoral discrimination, becomes such as to lead its administration to become too complex. Indeed, the larger is the number of sectors governed by specific dispositions, committees and bureaucracies, the larger the tendency for trade policy to be conducted at the "local" level. The more decentralized the system becomes, the more likely the tendency for a symbiosis between bureaucrats and businessman and for the "privatization" of state regulation of industrial activity. Decentralized systems should exhibit more inertia to change given the identification of regulators and their subjects in the preservation of established interests in a given industry. Different countries obviously differ in the extent to which state regulation has been "privatized" and the extent to which this disease is present in other areas of public policy.

5. Targeting in trade regimes

The interaction between trade and industrial policy tends to be large in Latin American countries given that, in foreign exchange constrained economies, the access to imports becomes the crucial industrial policy instrument and in this connection, the patterns of protection and export promotion over the years played a key role in the shaping of crucial features of industrial organization in Latin America. As often noted, the interaction between a restrictive trade regime and small market size relative to best-practice optimum scales led to the formation of high levels of concentration¹, and often the creation of a relatively stable oligopolistic structure is reinforced by the combination of (i) a high level of multinational penetration in response to restrictive import barriers coupled with relatively more liberal stance towards foreign capital; (ii) the creation of "national champions" by the special protection-~~and~~ domestic subsidies treatment given to domestic firms in some import substitution projects and stimulated by the concern with the creation of industrial "enclaves" that could be formed by vertically integrated MNC's affiliates; (iii) state ownership in sectors requiring large initial investment outlays, which created in fact monopolistic¹ oligopolistic public enterprises².

Non-contestability is thus an important feature in the industrial organization in Latin American countries emerging from an extended period of import substitution. In this connection, import liberalization and increased export orientation assume a dimension of competition policy. Traditionally, the concern about big business and restrictive market practices have been

¹ See Merhav (1969).

² For a more detailed discussion see Fritsch & Franco (1989b).

secondary in Latin America, and besides, governments could often be found enhancing such practices to the extent that they favor the processes aluded in the last paragraph. Thus, trade reform tend to face the issues involved in the discussion of anti-trust actions and, to a some extent, by-pass the resistences to anti-trust legislation and, in this connection, it may raise strong resistences from big business.

Targeting has been, therefore, an important element in import substitution processes in Latin America, and most of it has been carried through protection and heavy industrial regulation. The neo-classical literature emphasizes "rent-seeking" behavior as a crucial distortion emerging in systems in which QRs and heavy regulation predominate, and this is certainly an important issue to deal with. Yet, the concession of subsidies and rent creating regulation should not be seen as an evil in itself. The abandonment of such measures, which is openly advocated by liberalizers, means the abdication of any sectoral bias, or of any targeted character in commercial policies, which is not generally accepted very easily in countries with tradition in active industrial policies. In this connection, it is more common to find negative attitudes towards the non-transparency and low accountability in the concession of subsidies and in regulation practices and also towards the subsidies beyond the state fiscal capacity and ill conceived regulation governed by corporatist interests, than negative points of view against targeted trade policies *per se*.

More recent writings of liberalizes, to a great extent induced by the legitimacy conferred to targeted policies by "new trade theories" and some successful experiences in Asia, tend to call attention to the fact that even though targeted policies may be possible in theory, nothing can be said *a priori* about a given government capacity to properly identify opportunities

and act. More often than not, so the argument goes, "government failures" might become much more serious than market failures¹. One could hardly fail to recognize that "government failure" - multiplication of subsidies and rent creation, spurious regulation, privatization of regulatory functions, symbiosis between regulators and their subjects, etc. - has become pervasive in many Latin American countries.

In one way or another, however, targeting is likely to survive in more subtle ways. To the extent that liberalizations are gradual and obey a given sequencing in the dismantling of trade barriers, they necessarily become targeted. Whether one starts by consumer goods or capital goods and inputs, or one privileges inputs for exports, is a matter of choice often defined by resistances that stem from existing institutions and legislation and political economy considerations. Country experiences should certainly differ in this respect.

6. Summary

Through this paper, many issues related to trade reform and with a bearing on the political economy considerations were raised. By and large, the treatment was quite general and, wherever possible, it was observed that only a comparative view of country experiences could allow an in-depth examination. In light of these issues, if one would have to build a tentative content of country studies, the script, defined in very broad and preliminary level, could be broken into a few key elements: (i) The roots of new perceptions as to the need of reforming the trade regime - which may be

¹ For a recent exposition see Krüger (1990)

related to the quite general influences alluded in section 1 in a variety of ways - are paramount to the definition of the policy agenda. (ii) Past experience as far as macroeconomic developments and trade-offs, especially as regards developments following the debt crisis, are important to frame the "initial conditions" - which includes distributive conflicts, balance of payments conditions, levels of inflation, etc. - and to assess the degrees of freedom to be spared in liberalization, especially when coincident to stabilization. (iii) The formation of trade regimes now in place, their nature, "depth", and degree of centralization are important considerations in the combination of liberalization with changes in the style of trade and industrial policies, or with new attitudes towards regulation. (iv) In many cases, relations with multilateral organizations have been the fundamental determinant of policy moves towards liberalization, as well as its nature, so that the review of relations with these institutions is often very important. (v) The mechanisms by which changes in market structure and industrial regulation induced by liberalization would enhance dynamic efficiency and trade performance would clarify the design of liberalization and the choices available. (vi) Trade reform brings necessarily an implicit targeting that should reflect, on the one hand, lines of least resistance and, on the other, policy priorities defined in a transparent way.

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