Published as: "External Bindings and the Credibility of Reform", Francois, J.F., in A. Galal and B. Hoekman, eds., *Regional Partners in Global Markets*, Centre for Economic Policy Research , 1997.

# External Bindings and the Credibility of Reform

Joseph F. Francois
*WTO secretariat and CEPR*

July 1996
(revised)

---

disclaimer: This paper represents the opinions of the author, and is not meant to represent the position of the WTO secretariat or of WTO Members.

## ABSTRACT

EXTERNAL BINDINGS AND THE CREDIBILITY OF REFORM

July 1996

This paper examines enhancement of the credibility of economic policy reform through external trade and investment agreements. At one level, the role of NAFTA in anchoring recent reforms in Mexico is discussed. This is followed by more abstract treatment of how external policy bindings, through bilateral and/or multilateral agreements, may lend benefits related to the durability of reforms. In addition to helping secure the path of reform, such credibility signals may also have important effects related to assessments by international capital markets of reforms undertaken in the context of trade and investment agreements.

**JEL classification:** [O19, F13, F43].
**keywords:** policy reform, regional trade agreements, trade policy

disclaimer: This paper represents the opinions of the author, and is not meant to represent the position of the WTO Secretariat or of WTO Members. Thanks are due to the participants at an Egyptian Centre for Economic Studies conference on "How Can Egypt Benefit From a Trade Agreement with the EU?"

Joseph Francois
Economic Research and Analysis Unit
World Trade Organization
rue de Lausanne 154
CH1211 Geneva 21
Switzerland
voice: +41 22 739.52.78
fax: +41 22 739.57.62
Joseph.Francois@WTO.ORG

## NONTECHNICAL SUMMARY

Over the last two decades, there has been a fundamental shift in the domestic policy and outward orientation of developing and transition economies. This shift has been away from inward oriented development polices and toward a mix of outward-oriented, market-based policies (good practices) believed to be condusive to sustained development and growth. This set includes good governence, macroeconomic stabilitiy, an open trade and investment regime, market orientation, protection of property rights, and enforcement of contract law. (Rodrik 1996). While the emphasis on particular aspects of this policy mix may vary, an emerging concensus is that the greater the overlap between actual policy and the optimal set of policies, the greater the chances for sustained growth and eventual convergence with OECD income levels. In this context, the recent round of policy reforms can be characterized as efforts to move the domestic policy mix closer to congruence with the good practice set.

This most recent movement to market based policies has also served to highlight the importance of political economy constraints in the economic reform process. As Williamson (1990) has emphasized, not all stable policy regimes are characterized by good practice. In fact, through most of history, and across most of the world, regimes condusive to stagnation and decline have been remarkably tenacious and even robust. At this point, the fundamental problem of development economics is perhaps not so much the identification of good practices, but rather the identification of the institutional arrangements necessary for the sustainability of such practices. Not surprisingly, given the demonstrated difficulties inherent in pursuing good long-run policies both through painful short- and medium-run adjustments, and through sustained pressures of rent seeking (and rent preservation), a common theme to emerge in some of the recent development literature is the potentially positive role, at least in the economic arena, that can be played by a strong, stable central government in anchoring such policies. Examples offered in this regard include Chile and Korea. This paper explores the alternative (or complementary) option of anchoring policy through regional or multilateral agreements that bind offer external bindings on trade, investment, competition, and related economic policies in contractual agreements.

Concurrent with the shift over the 1980s in development orientation, there has also been both a shift in the pattern of regionalism, and an increased participation by developing countries in the multilateral system. Both have ramifications for the institutional context of reform. In the 1980s, the most successful efforts at expanded regional integration involved OECD countries in North America and Western Europe. However, since then, these regional trading blocks have expanded their reach to developing and transition countries, resulting in North-South regional agreements. This differs from earlier preferential arrangements, in that the new set of agreements tends to be contractual, and involves requirements for economic restructuring and reform on the part of South members. In the case of both EU partner agreements and the North American Free Trade Agreement (NAFTA), motivation can be found in an expressed interest in economic and political stability at the borders.

This paper is concerned with the potential benefits to developing and transition economies of enhancing the credibility of economic policy reforms through external agreements that secure a role for large partners as regional policy anchors. At a concrete level, the role of NAFTA in anchoring recent policy reforms in Mexico is discussed. Emphasis is placed on the role of the United States as a policy reform anchor. This is in contrast to the earlier NAFTA literature, particularly the CGE literature surveyed by Francois and Shiells (1994), which emphasized the impact of expected reductions in tariffs and NTBs. The critical overview of NAFTA is followed by a more abstract treatment, with reference to the Mexican case, of how external policy bindings, through bilateral and/or multilateral agreements, may lend an air of credibility to economic reforms. In addition to helping secure the path of reform, such credibility signals may also have important effects related to assessments by international capital markets of reforms undertaken in the context of trade and investment agreements. The paper concludes with discussion of the insights for the potential role of the EU as a policy reform anchor in the context of the Europe Agreements and the EU agreements with the Mediterranean countries.

Can we reasonably expect that a mix of regional agreements with the EU and NAFTA blocks, combined with multilateral obligations, can serve as credible policy anchors? Based on the Mexican experience, *including the peso crisis*, the answer is a qualified yes. However, the market forced a testing of the credibility of the reform anchors, demanding strong intervention by the United States and IMF. It is unreasonable to expect the degree of financial commitment to exhibited by the United States to hold in other situations. Hence, the Mexican experience highlights both the importance of external partners that value the internal policy reforms enough to force adherence to external obligations, and the importance of rational macroeocnomic policies (like the exchange rate) as a backdrop to radical microeconomic reform. If the anchor is to provide macro credibility, then this in turn suggests that such external anchors must carry weight in financial markets and in international institutions.

Are these conditions met outside of Mexico? In some areas, particularly around the EU, the answer would seem to be yes. This includes Central and Eastern, where there a parallels to the U.S. concern about stability and prosperity at the border. The move toward EU integration can be viewed as a move toward cementing market reforms. What about the Mediterranean countries? Here again, there is a parallel with concerns about underlying demographic trends and migration. The model of anchored policy reform may potentially prove relevant in the long run for the Mediterranean countries as well. However, this will require both real commitment on the part of the EU, and real bindings on internal policies on the part of the Mediterranean countries. This includes binding, enforceable commitments on foreign direct investment regimes, and perhaps enough preferential liberalization in trade and investment to encourage commercial interest on the part of the anchor partner. Across the region, these steps have yet to be taken. Reform anchors only work if there are reforms to anchor. Otherwise, subsequent benefits related to improvements in the conditions imposed by international financial markets will not be realized.

## EXTERNAL BINDINGS AND THE CREDIBILITY OF REFORM

### 1. INTRODUCTION

Over the last two decades, there has been a fundamental shift in the domestic policy and outward orientation of developing and transition economies. This shift has been away from inward oriented development polices and toward a mix of outward-oriented, market-based policies (good practices) believed to be condusive to sustained development and growth. This set includes good governence, macroeconomic stabilitiy, an open trade and investment regime, market orientation, protection of property rights, and enforcement of contract law. (Rodrik 1996). While the emphasis on particular aspects of this policy mix may vary, an emerging concensus is that the greater the overlap between actual policy and the optimal set of policies, the greater the chances for sustained growth and eventual convergence with OECD income levels. In this context, the recent round of policy reforms can be characterized as efforts to move the domestic policy mix closer to congruence with the good practice set.

This most recent movement to market based policies has also served to highlight the importance of political economy constraints in the economic reform process. As Williamson (1990) has emphasized, not all stable policy regimes are characterized by good practice. In fact, through most of history, and across most of the world, regimes condusive to stagnation and decline have been remarkably tenacious and even robust. At this point, the fundamental problem of development economics is perhaps not so much the identification of good practices, but rather the identification of the institutional arrangements necessary for the sustainability of such practices. Not surprisingly, given the demonstrated difficulties inherent in pursuing good long-run policies both through painful short- and medium-run adjustments, and through sustained pressures of rent seeking (and rent preservation), a common theme to emerge in some of the recent development literature is the potentially positive role, at least in the economic arena, that can be played by a strong, stable central government in anchoring such policies. Examples offered in this regard include Chile and Korea. This paper explores the alternative (or complementary) option of anchoring policy through regional or multilateral agreements that bind offer external bindings on trade, investment, competition, and related economic policies in contractual agreements.

Concurrent with the shift over the 1980s in development orientation, there has also been both a shift in the pattern of regionalism, and an increased participation by developing countries in the multilateral system. Both have ramifications for the institutional context of reform. In the 1980s, the most successful efforts at expanded regional integration involved OECD countries in North America and Western Europe. However, since then, these regional trading blocks have expanded their reach to developing and transition countries, resulting in North-South regional agreements. This differs from earlier preferential arrangements, in that the new set of agreements tends to be contractual, and involves requirements for economic restructuring and reform on the part of South members. In the case of both EU partner agreements and the North American Free Trade Agreement (NAFTA), motivation can be found in an expressed interest in economic and political stability at the borders.

The Europe Agreements aim to establish bilateral free trade agreements with several Central European countries. These Agreements offer access to the EU market free of tariff and quantitative restrictions, and are linked to the Copenhagen European Council's decision in 1993 that associated countries could accede to the EU after political and economic criteria are met. Hence, the promise of preferential access to the EU has been linked closely to human rights conditions and mechanisms related to consultations on economic, monetary, and industrial policy cooperation. While the process of developing EU agreements with the Mediterranean countries is not as well advanced or as far reaching, the EU has explicitly linked its overall policy in the region to concerns about demographic, economic, and political trends (i.e. migration incentives and political stability). Cyprus and Malta are associated countries, while Turkey has entered in a customs union. Negotiating rounds have been held with Egypt since the approval of a mandate in December 1994, while various stages in the process, ranging from preparatory talks to initialled agreements, have been reached with Algeria, Lebanon, Morocco, and Tunisia. (WTO 1995).

This paper is concerned with the potential benefits to developing and transition economies of enhancing the credibility of economic policy reforms through external agreements that secure a role for large partners as regional policy anchors. At a concrete level, the role of NAFTA in anchoring recent policy reforms in Mexico is discussed. Emphasis is placed on the role of the United States as a policy reform anchor. This is in contrast to the earlier NAFTA literature, particularly the CGE literature surveyed by Francois and Shiells (1994), which emphasized the impact of expected reductions in tariffs and NTBs. The critical overview of NAFTA is followed by a more abstract treatment, with reference to the Mexican case, of how external policy bindings, through bilateral and/or multilateral agreements, may lend an air of credibility to economic reforms. In addition to helping secure the path of reform, such credibility signals may also have important effects related to assessments by international capital markets of reforms undertaken in the context of trade and investment agreements. The paper concludes with discussion of the insights for the potential role of the EU as a policy reform anchor in the context of the Europe Agreements and the EU agreements with the Mediterranean countries.[1]

## 2. THE OPENING OF THE MEXICAN ECONOMY

### 2.1 Background

Mexico's pursuit of a free trade agreement with the United States and Canada (the NAFTA) followed a series of unilateral and negotiated reforms aimed at opening the Mexican economy. This section provides a brief overview of these reforms, highlighting the binding of border measures and the liberalization of foreign investment restrictions.

Starting with its GATT accession, Mexico started a dramatic process of restructuring and reorientation in the 1980s. In accordance with its GATT accession obligations, Mexico began dismantling its previously universal regime of import-licensing requirements in 1985. Manufactured products in particular benefitted from this liberalization process. By the end of 1991, only 8 percent of its imports from the United States (though 30 percent of agricultural imports) were covered by these restrictions. Other reforms implemented prior to NAFTA related to intellectual property, foreign exchange restrictions, foreign investment, and privatization. By 1991, Mexican Government holdings in three large steel interests had been divested, as had Telefonos de Mexico (TELMEX) and the Banco Nacional de Mexico (BANAMEX). (The banking system had been nationalized in 1982). The government also repealed the peso's controlled exchange rate, abandoning official exchange controls that had been in effect since 1982.

Improvements in intellectual property rules followed Special 301 action by the United States. In 1989, the United States placed Mexico on a priority watch list under Special 301, citing lack of intellectual property rights protection. Mexico was removed from the list following government promises to reform earlier law, a change implemented in 1991.

Formal consultation mechanisms with the United States were also in place before the NAFTA negotiations. These reflected the pattern of bilateral disputes. In conjunction with Mexico's GATT accession, Mexico concluded the Framework of Principles and Procedures for Consultation Regarding Trade and Investment Relations in 1989. This Framework established a mechanism for consultations on trade and investment issues. This was followed by the Understanding Regarding Trade and Investment Facilitation Talks (TIFTs). In some areas, work begun under the TIFTs served as the basis for NAFTA negotiations.

**[ Table 1 Here ]**

### 2.2 Mexico's tariffs

The overall pattern of Mexican tariffs, for the period spanning from 1982-1991, is presented in Table 1. The level of tariffs in the table reflects the episode of liberalization following Mexico's 1982 financial crisis. As part of Mexico's accession to the GATT in 1986, Mexico agreed to bind its entire tariff schedule, including both industrial and agricultural products, at a 50 percent ad valorem rate.[2] In the year prior to accession (1985), the average tariff had been 18.5 percent. However, while the average tariff in 1985 was 18.5 percent, some products were dutied at rates of up to 100 percent. The average tariff on consumer goods in the year prior to GATT accession was 45 percent. Since accession, Mexico's average tariffs have ranged between 4.0 percent and 13.1 percent. The range of tariffs has been capped by Mexico's ceiling bindings. A further cap on tariffs was imposed by Mexico's entry into the North American Free Trade Agreement (NAFTA). From 1967 to 1990, the aggregate U.S. and Canadian share of Mexican imports has hovered around 65 percent. (See Figure 1). The combined effects of GATT accession and the approval of NAFTA has been to significantly limit Mexico's scope for raising trade barriers through tariffs. There are now caps that, though often above current rates, are well below the historically observed peak rates. Through NAFTA and the GATT/WTO, Mexico has combined the process of import and foreign investment liberalization with the undertaking of external obligations that greatly limit its ability to dismantle these reforms.

**[ Figure 1 Here ]**

**2.3 The credibility of the reforms**

What has been the effect of this binding of trade and foreign investment policy? Arguably, a partial (and somewhat harsh) credibility test was provided shortly after ratification of NAFTA, with the peso crisis. (The movement in foreign reserves associated with this crisis is presented in Figure 2.) This crisis followed financial and public relations mismanagement by the Mexican government. While not linked to the reforms per se, the ensuing financial market reactions nontheless threatened the over sustainability of the policy regime.

**[Figure 2 Here ]**

An important aspect of Mexico's policy of openness relates to liberalization of barriers to foreign investment. (See Kehoe 1996). The surge of investment in Mexico leading up to the crisis followed growing confidence in the Mexican reform process, and also a significant easing of restrictions on foreign investment grounded in the 1973 Law on Foreign Investment. However, much of the investment surge observed in this period (during NAFTA negotiation and ratification) was short-term investment, and much of this was borrowed by the government, in dollars, to finance public debt on a short-term basis. Kehoe provides a blow-by-blow account of the events leading to the rapid withdrawal of these portfoilo funds following a series of political crises that were more or less unrelated to the basic structure of economic reform, but which still had the effect of conveying a profound sense of political instability. The crisis was linked to the politics of NAFTA in Mexico, though not directly to the policy mix itself. One result of this type of capital market crisis, under past regimes, would most certainly have involved exchange controls and a dramatic increase in levels of protection to address weakness in the capital account. This was the legacy of the crisis in the early 1980s, which in addition had been accompanied by nationalizations.

The actual outcome was quite different from past experience. With critical support (both financial and political) from its principal NAFTA partner, the United States, intervention was targeted at stabilization without sacrificing the move toward an open regime. President Clinton arranged for a $50 billion line of international credit in Spring 1995, including $20 billion directly from the United States (and additional funds "coaxed" from the IMF). The Mexican government borrowed $12.5 billion of the American credit line By January 1996, $2 billion had already been paid back, and currency reserve levels had largely recovered, though the government still owed $10.5 billion to the U.S. Treasury and another $11 billion to the International Monetary Fund. Also by January 1996, dollar denominated short-term government debt (Tesebonos) had been reduced from a peak of $29 billion in the beginning of 1995 to $115.7 million. The economy was also recovering from a deep recession by early 1996, led by dramatic export growth, particularly to NAFTA partners. (See Figure 1). As Kehoe states "It is important to note that, throughout the 1994-95 financial crisis in Mexico there was no serious discussion of imposing the sort of exchange rate restrictions as were used in 1982."

## 3. THE BENEFITS OF IMPROVED SECURITY

What benefits can a relatively small country expect to gain from pursuit of bilateral and multilateral bindings on its room for meneuvre on trade and investment policy? In particular, do external bindings on domestic policy offer any advantages over unilateral liberalization? In

Mexico's case, potential benefits relate to (i) security of current preferential access to the United States market, (ii) improved access to the United States market, and (iii) the role of the U.S. as an external policy anchor for domestic reform. Among these, while improved access was clearly important, it was not the dominant element. Rather, the most important aspects of these effects relate to market security. In recent history, protection has been much higher on the Mexican side of the border than the U.S. side. Prior to the NAFTA, most of Mexico's exports to the United States already benefitted from duty-free or preferential access. (See Table 2). However, preferential access to the U.S. market was not contractual (i.e. was not guaranteed). Rather, as can be seen in Table 2, these preferences resulted from offshore assembly provisions of the U.S. tariff code, and from the U.S. GSP programme. There was no obligation on the part of the United States to maintain Mexican eligibility for either of these programmes. Clearly, therefore, an important source of expected benefits related not to U.S. tariff reduction per se, but rather to the reduction in commercial policy uncertainty associated with current preferential access. Combined with the locking of Mexico and its North American trading partners into commitments that anchored domestic reform, the result was a substantial increase in foreign direct investment, and a lowering of the risk premium for Mexico, in turn lowering interest rates.

**[ Table 2 Here ]**

This section briefly examines, analytically, some aspects of each of these mechanisms. The point is that policy reform, undertaken in the context of binding external agreements, may carry more credibility than otherwise. The net result is a reduction in policy uncertainty. The reduction of policy uncertainty in this way has a number of important positive implications.

### 3.1 The expected cost of import protection

Since the establishment of GATT in 1947, average industrial tariff protection in the OECD has fallen to less than 5 percent, while the variance of individual bound tariffs has been virtually eliminated. However, the stochastic nature of protection has remained strongly evident across individual sectors and instruments free from, or lightly constrained by, binding trade rules. Thus, protection rates have varied substantially in areas such as agriculture (in both developed and developing countries) and in industrial products in developing countries. When we look beyond bound tariffs on industrial goods, we find that a wide range of measures such as variable levies, import quotas, voluntary export restraints (VERs), import surcharges, and the various forms of contingent protection (such as balance of payments actions, anti-dumping and countervailing duties) continues to be used to generate time-varying rates of protection.

To deal with this inherent commerical policy uncertainty, a key feature of multilateral liberalizations has been the introduction of tariff and other instrument bindings which constrain the range and variability of protection rates. For example, while tariff bindings allow tariff rates to vary below the level of the binding, they reduce both the average applied tariff and the variability of the applied rate of protection. Drawing on the extensive literature on the political economy of protection for support, Francois and Martin (1995) have argued that the political economy pressures that cause protection rates to vary are likely to continue to generate varying rates of protection even after the introduction of new commerical policy bindings. In such a setting, the potential benefits of additional bilateral and multilateral liberalizations will be related to both the average level of protection *and its variance.*

Bindings are vital to the process of securing trade agreements. If an agreed tariff reduction could be unilaterally reversed, any liberalization offer would have to be weighed against the probability of backsliding. Exporting firms, which provide much of the political support for bilateral and multilateral trade and investment liberalization, are likely to be unenthusiastic about tariff cuts they expect to be short-lived. Bindings themselves are considered to be so important that, in the GATT/WTO context, countries agreeing to bind previously unbound tariffs are given "negotiating credit" for the decision. This is true even if the tariff is bound above the currently applied level. Similar qualifications apply to investor enthusiasm under the threat of uncertain foreign exchange restrictions or similar measures.

Some of the welfare implications of bindings are illustrated in Figure 3 for the case of a small country, with symmetric variations in protection. (See Francois and Martin 1995 for a treatment with a generalized temporal distribution of protection). In the figure, the downward sloping line represents the compensated import demand curve. With a fixed tariff, the welfare cost of protection is defined by the Harberger triangle *cab* under the excess demand curve. Alternatively, consider symmetric variations around this tariff level, with a higher tariff yielding a higher domestic price $P_h$ in one time period and a lower one $P_L$ in another. The welfare cost of the higher tariff is *cfg*, and of the lower tariff is *cde*. The reader can verify that the average of these areas (the expected cost of protection) exceeds the cost of protection under a fixed tariff. Under more general conditions (Francois and Martin 1995), it can be shown that the expected cost of protection is a function of the first and second moments of protection. For this reason (and as illustrated in Figure 3), the expected cost of protection, for a given average tariff level, is higher when that tariff is uncertain. This benefit of bindings relates to expected utility, and is apart from investment-related benefits of reduced uncertainty (discussed below). It follows from the geometric aspect of the welfare costs of price distortions. The expected benefits of reduction in uncertainty will be further magnified, for small countries, when preferences reflect risk aversion.[3]

**[ Figure 3 Here ]**

### 3.2 The expected cost of protection in export markets

By similar arguments, benefits can be identified related to secured market access conditions in export markets. However, the benefits depend critically on the nature of the security. Consider again a small exporter, with the excess import demand curve again represented in Figure 3. We now assume away home import policy variance, and focus instead on uncertainty in foreign market access conditions. Free trade is represented by price line $P^*$. We again assume symmetric variations in protection, though this time as reflected in market access conditions for exports.

Exports are determined by the terms of trade and import demand, as reflected in the intersection of the world price line for importables. If protection in export markets is low, terms-of-trade are relatively favourable, and trade occurs along world price line $P_l$. Alternatively, with high protection in export markets, terms-of-trade are given by $P_h$. The welfare costs of these two states, compared to free trade, are $P_hP^*cf$ and $P_lP^*cd$ respectively.

What are the implications of price stability through bindings? Cleary, if market access can be secured at the lower level of protection, $P_1$, then the move is welfare improving. As the current example of China and unsecured MFN treatment in the U.S. market has highlighted, secure MFN access (i.e. secured access at the "best available rate") is better than unsecured access. However, consider also a stabilized level of protection at the mean level $P$. In the present example, if we compare the welfare effects of the varied states (in terms of shifting terms-of-trade effects) with the fixed state P, in the absence of risk aversion, variable terms of trade are preferred. The reader can varify this by adding the relevant squares and triangles under the excess demand curve. Again, this is analogous to well known results in the price stabilization literature, this time for demand agents (or in our example the importer). The actual welfare implications of bindings on the part of trading partners will depend critically on the elasticity of demand, possibilities for consumption smoothing, and relative risk aversion.

Basically, in terms of expected utility analysis, commercial policy stability in both import and export markets is analogous to commodity price stabilization. For a small country, the benefits, analogous to the supplier benefits under commodity price stabilization, follow from the imposition of own-security. There may also be benefits from foreign market access security, but this hinges on the nature of commercial policy security on the export market side, as well as on relative risk aversion of home economic agents. A basic point here is that the national welfare benefits of secure commercial policy are much more evident for securing one's own policies than for securing partner policies.

**[ Figure 4 Here ]**

### 3.3 Dynamic effects

Another set of effects is likely to follow from a generally improved commercial policy environment. In the case of Mexico, this has been emphasized by Kehoe (1994) and Romero (1994). It is illustrated conceptually in Figure 4, where the curve $MP_K$ represents the marginal product of capital, and where the line $r^*$ represents current lending conditions on international capital markets. Conditions for international capital lending will reflect a number of factors, including risk of nationalization (i.e. Mexico in 1982), and the security provided by outside obligations (like the Mexican GATT accession in 1986 and the NAFTA in 1993). As elements are added that reduce the underlying risk premium, this is reflected in a shift in $r^*$ to $r^{*\prime}$. In Figure 4, the national income gain from this reduced risk premium is the area *abcd*. This is related to expanded production and rising labour productivity and wages. Arguably, this effect may be one of the most important medium- to long-run effects of investment-related external policy reform anchors.

## 4. CAN WE GENERALIZE?

This paper has drawn from the Mexican experience to develop a set of stylized effects that may follow from externally anchored policy reforms, particularly in the context of North-South trade agreements. The basic thesis has been that reduced policy uncertainty, in terms of trade and investment policy, can have important effects, above those related to simple unilateral changes in the level of intervention. In the case of Mexico, GATT accession and the NAFTA both have served to anchor domestic policy reform, lending credibility to the Mexican Government's ongoing policy of openness or *apertura*.

The question left unanswered is whether these elements can be orchestrated in other trade and investment agreements entered by other developing regions. In particular, what lessons can we draw from this experience for the broader set of developing and transition countries? Can we reasonably expect that a mix of regional agreements with the EU and NAFTA blocks, combined with multilateral obligations, can serve as credible policy anchors? Again, based on the Mexican experience, *including the peso crisis*, the answer is a qualified yes. However, the market forced a testing of the credibility of the reform anchors, demanding strong intervention by the United States and IMF. It is unreasonable to expect the degree of financial commitment to exhibited by the United States to hold in other situations. Hence, the Mexican experience highlights both the importance of external partners that value the internal policy reforms enough to force adherence to external obligations, and the importance of rational macroeocnomic policies (like the exchange rate) as a backdrop to radical microeconomic reform. If the anchor is to provide macro credibility, then this in turn suggests that such external anchors must carry weight in financial markets and in international institutions.

Are these conditions met outside of Mexico? In some areas, particularly around the EU, the answer would seem to be yes. This includes Central and Eastern, where there a parallels to the U.S. concern about stability and prosperity at the border. The move toward EU integration can be viewed as a move toward cementing market reforms. What about the Mediterranean countries? Here again, there is a parallel with concerns about underlying demographic trends and migration. The model of anchored policy reform may potentially prove relevant in the long run for the Mediterranean countries as well. However, this will require both real commitment on the part of the EU, and (as Hoekman and Djankov 1995 have emphasized), real bindings on internal policies on the part of the Mediterranean countries. This includes binding, enforceable commitments on foreign direct investment regimes, and perhaps enough preferential liberalization in trade and investment to encourage commercial interest on the part of the anchor partner. Across the region, these steps have yet to be taken. Reform anchors only work if there are reforms to anchor. Otherwise, subsequent benefits related to improvements in the conditions imposed by international financial markets will not be realized.

## REFERENCES


Finger, M., U. Reincke, and M. Ingco, (1996). "The Uruguay Round: statistics on tariff concessions given and taken." World Bank mimeo, February.

Francois, J. and W. Martin (1995). "Multilateral trade rules and the expected cost of protection." CEPR discussion paper 1214, July.

Francois, J. and C. Shiells (1994). *Modeling Trade Policy: Applied General Equilibrium Assessments of North American Free Trade*, Cambridge University Press.

Hoekman, B. and S. Djankov (1995). "Catching up with Eastern Europe? The European Union's Mediterranean Free Trade Initiative." CEPR discussion paper 1300, November.

Kehoe, T. (1994). "Toward a dynamic general equilibrium model of North American Trade," in J. Francois and C. Shiells, eds., *Modeling Trade Policy: Applied General Equilibrium Assessments of North American Free Trade*, Cambridge University press.

Kehoe, T. (1996). "Capital flows and North American Economic Integration." in J. Francois and R. Baldwin, eds., *Dynamic Issues in Applied Commercial Policy Analysis*, CEPR and Cambridge University Press, forthcoming.

North, D. (1990). *Institutions, Institutional Change, and Economic Performance*, Cambridge University Press.

Rodrik, D. (1996). "Understanding economic policy reform." *Journal of Economic Literature* XXXIV (March), 9-41.

U.S. International Trade Commission (1992). *The Year in Trade -- Operation of the Trade Agreements Program*, USITC publication 2554, August.

World Trade Organiztion (1995). *Trade Policy Review -- European Union*, volume 1, Geneva.

World Trade Organization (1995). *International Trade 1995: Trends and Statistics*, Geneva.

Young, L. and J. Romero (1994). "A Dynamic dual model of the North American Free Trade Agreement." in J. Francois and C. Shiells, eds., *Modeling Trade Policy: Applied General Equilibrium Assessments of North American Free Trade*, Cambridge University Press.

## Endnotes

1. Hoekman and Djankov (1995), in their discussion of the Euro-Mediterranean Agreement between the EU and Tunisia also place emphasis on credibility. In the case of the Tunisian EMA, they argue that there is an absence of binding commitments in a number of important areas, including services and investment.

[2.] The exception was any imports already covered by lower bindings. Mexico also negotiated quotas were also negotiated for certain products (primarily agricultural and wood-based products) under bound rates. See GATT(1993).

3. Note that this result will also hold in frameworks where consumption smoothing is possible, since reduction in policy uncertainty will reduce the expected costs of consumption smoothing (i.e. borrowing).

**Table 1.**
**Trade-weighted structure of Mexican tariffs, 1982-1991**

| tariff rates | Imports (US $ million) 1982 | 1983 | 1984 | 1985 | 1986 | 1987 | 1988 | 1989 | 1990 | 1991 |
|---|---|---|---|---|---|---|---|---|---|---|
| duty-free | 3075.1 | 3174.2 | 3586.7 | 368.2 | 3004.5 | 4836.9 | 7664.4 | 4893.4 | 5172.2 | 5771.9 |
| 2 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0 .0 | 0.0 |
| 5 | 1458.1 | 793.6 | 1135.3 | 1487.2 | 0.0 | 823.6 | 1537.8 | 247.1 | 290.3 | 388.8 |
| 10 | 5312.8 | 2853.7 | 4229.7 | 3269.7 | 3556.6 | 1452.2 | 1415.0 | 6979.0 | 7630.1 | 11531.5 |
| 15 | 216.6 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 2102.2 | 3085.4 | 4205.7 | 6954.1 |
| 17.5 | 0.0 | 0.0 | 0.0 | 0.0 | 18.5 | 742.8 | 0.0 | 0.0 | 0 .0 | 0.0 |
| 20 | 1761.3 | 206 | 231.1 | 129.8 | 6.6 | 0.0 | 1861.2 | 2999.2 | 4266.0 | 6078.6 |
| 22.5 | 0.0 | 0.0 | 0.0 | 0.0 | 1347.2 | 0.0 | 0.0 | 0.0 | 0 .0 | 0.0 |
| 25 | 375.4 | 290 | 492.3 | 1522.7 | 120.8 | 0.0 | 0.0 | 0.0 | 0 .0 | 0.0 |
| 27.5 | 0.0 | 0.0 | 0.0 | 0.0 | 25.5 | 0.0 | 0.0 | 0.0 | 0 .0 | 0.0 |
| 30 | 433.1 | 7.6 | 10.0 | 118 | 22.2 | 0.0 | 0.0 | 0.0 | 0 .0 | 0.0 |
| 35 | 28.9 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0 .0 | 0.0 |
| 37 | 0.0 | 0.0 | 0.0 | 0.0 | 954.8 | 0.0 | 0.0 | 0.0 | 0 .0 | 0.0 |
| 40 | 462.0 | 190.8 | 211.0 | 1133.1 | 4.6 | 0.0 | 0.0 | 0.0 | 0 .0 | 0.0 |
| 45 | 0.0 | 0.0 | 0.0 | 0.0 | 394.9 | 0.0 | 0.0 | 0.0 | 0 .0 | 0.0 |
| 50 | 534.2 | 22.9 | 70.3 | 365.9 | 0.0 | 0.0 | 0.0 | 0.0 | 0 .0 | 0.0 |
| 60 | 115.5 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0 .0 | 0.0 |
| 70 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0 .0 | 0.0 |
| 75 | 173.2 | 30.5 | 10.1 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0 .0 | 0.0 |
| 80 | 14.4 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0 .0 | 0.0 |
| 100 | 476.4 | 61.0 | 70.3 | 94.4 | 0.0 | 0.0 | 0.0 | 0.0 | 0 .0 | 0.0 |
| total imports dutied | 14437.0 | 7630.3 | 10046.8 | 8489.0 | 9456.2 | 7855.5 | 14580.6 | 18204.1 | 21564.3 | 30724.9 |
| imports dutied over 50 % | 1313.7 | 114.4 | 150.7 | 460.3 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| weighted tariff | 16.4 | 8.0 | 8.5 | 18.5 | 13.1 | 4.0 | 6.2 | 9.7 | 10.5 | 11.2 |

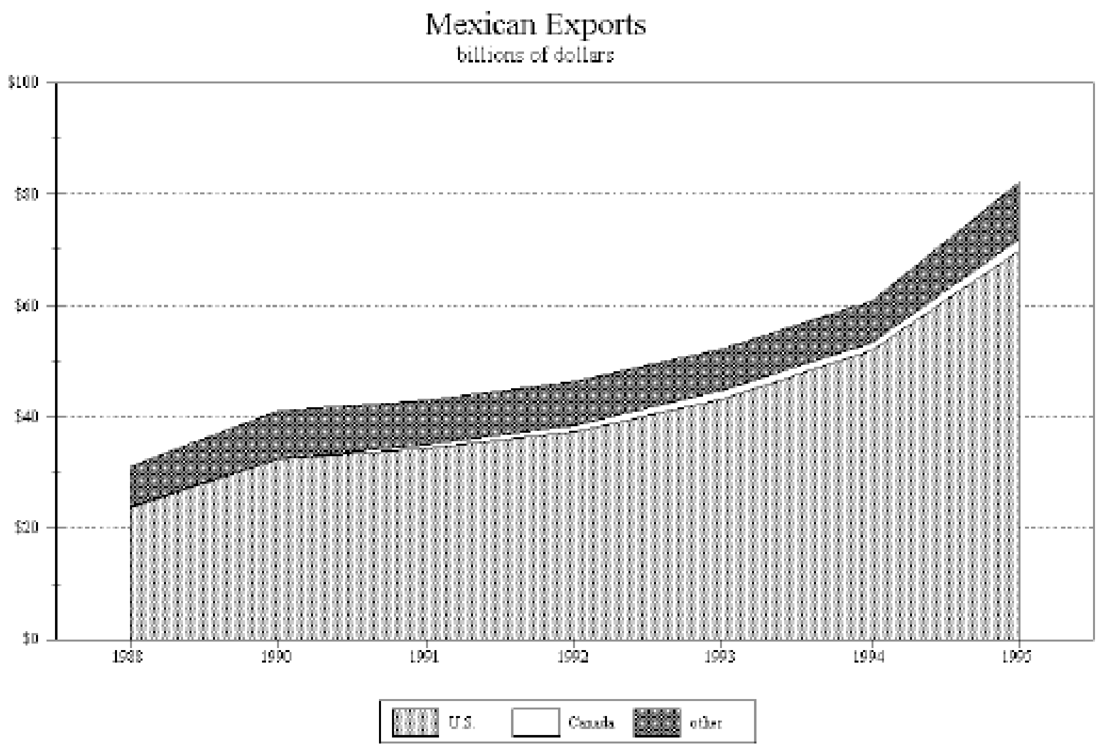
source: GATT(1993), Table IV.3.
Trade levels exclude imports subject to variable specific duties, which are only relevant for 1991, and cover less than 1 percent of imports.

**Table 2**
U.S. Imports from Mexico, 1991
(value in millions of dollars, and percent)

| | value | share |
|---|---|---|
| HTS 9802 (offshore assembly items) | 6,751.4 | 47.1 |
| GSP-imports | 1,806.1 | 12.6 |
| Petroleum (dutied at 0.7 percent) | 2,178.8 | 15.2 |
| Other | 3,597.8 | 25.1 |
| TOTAL | 14,334.1 | 100.0 |

source: USITC (1992)

**Figure 1**



Mexican Exports
billions of dollars
$100
$80
$60
$40
$20
$0
1988
1990
1991
1992
1993
1994
1995
U.S.
Canada
other

**Figure 2**

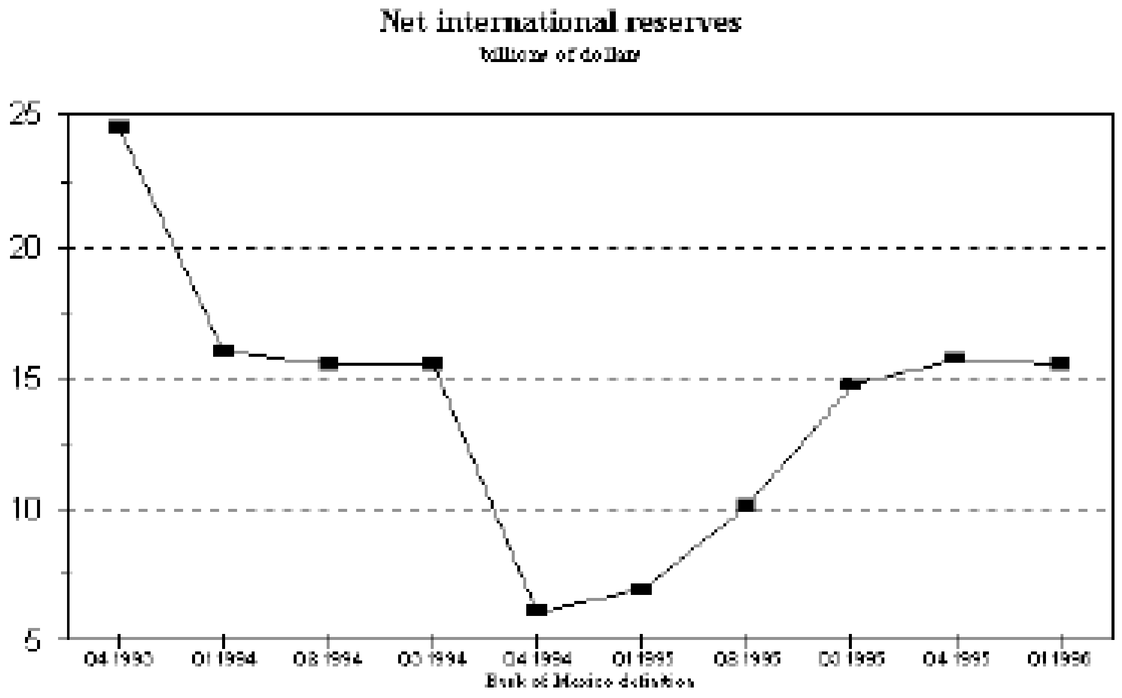

Net international reserves
billions of dollars
25
20
15
10
5
Q4 1993
Q1 1994
Q2 1994
Q3 1994
Q4 1994
Q1 1995
Q2 1995
Q3 1995
Q4 1995
Q1 1996
Bank of Mexico definition

**Figure 3**

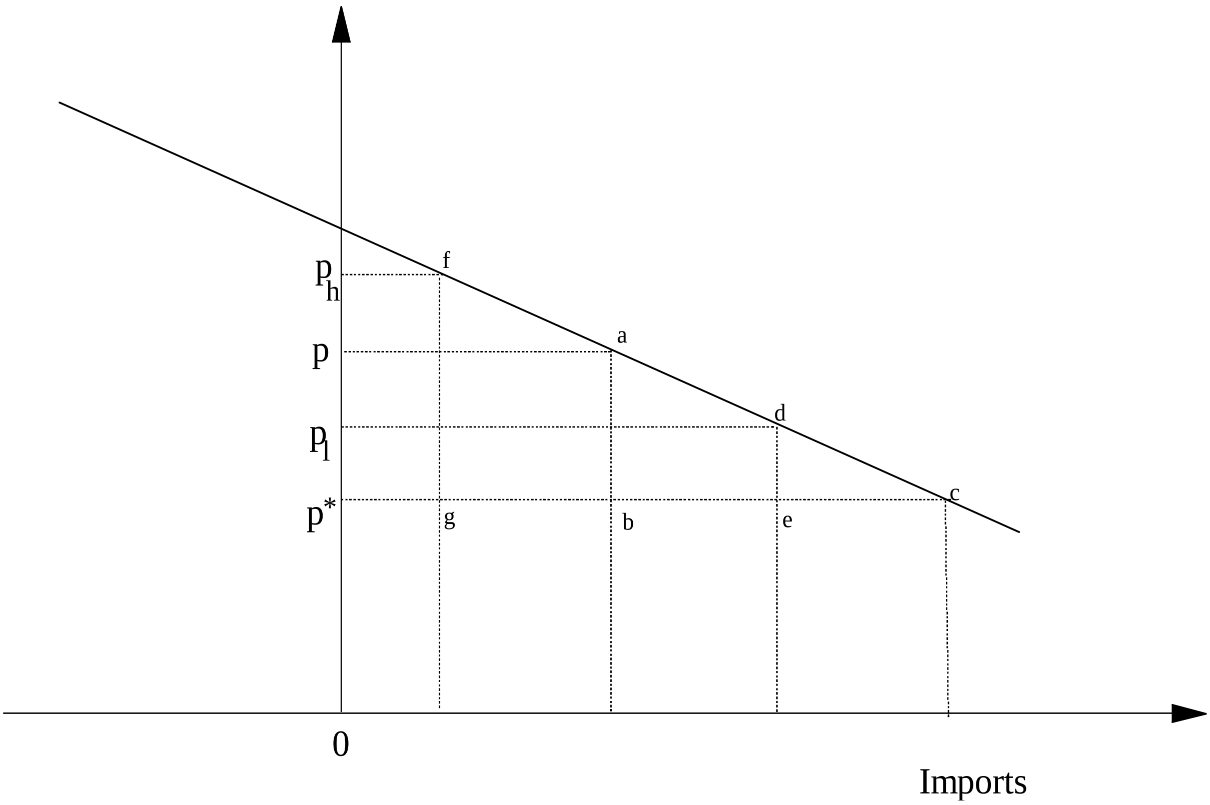


**Figure 4**