External Environment, Globalization and Reform

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Abstract

In response to increased global economic integration in recent decades, some countries took measures to align domestic incentives with the external environment, while others only made partial adjustments with a considerable time lag. This paper attempts to explain why reactions to changes in the external environment have been so varied. It traces the evolution of the external environment, documents the pattern of responses to these changes, and reviews a number of competing explanations of reform variability. The paper also provides a comparative analysis of the reform experiences of Latin America and the Middle East over the last two decades. Finally, it suggests a set of hypotheses for further analysis of the link between reforms and the external environment.

ملخص

في مواجهة تزايد الاندماج الاقتصادي العالمي في العقود الأخيرة، قام بعض الدول بإصلاحات اقتصادية كبيرة لمواءمة الحوافز في السوق المحلي مع هذا التغير في المناخ العالمي، بينما قامت دول أخرى بإصلاحات جزئية وبطيئة. وتناقش هذه الورقة أسباب هذا التباين في استجابة الدول، بدءا باستعراض أوجه التغير في المناخ العالمي، ومرورا بتحديد نمط وطبيعة الاستجابة لهذا التغير، وانتهاء بطرح مجموعة من التفسيرات لاختلاف ردود الأفعال. كذلك، تقارن الورقة بين تجارب أمريكا اللاتينية والشرق الأوسط خلال العقدين الأخيرين، ثم تقترح مجموعة من الفرضيات لمزيد من الدراسة والتحليل حول طبيعة العلاقة بين الإصلاح الاقتصادي والمناخ الخارجي.

I. Introduction

The past three decades have marked an extraordinary era of economic integration among nations. Economic integration increased in the 1970s and 1980s and accelerated sharply after the collapse of communism in 1989. Integration in the 1990s produced increased trade and financial flows, as well as the incentives to harmonize domestic regulatory policies across countries. In response, some countries followed prudent macroeconomic policies, privatized state-owned enterprises, liberalized domestic markets, and opened their economies to trade and capital flows. Others partially responded, though with a considerable time lag. Why are there such different responses to changes in the external environment? This is the broad question addressed in this paper. Specifically, the paper traces the evolution of the main changes in the external environment, documents the pattern of responses to these changes, reviews a number of competing explanations of reform variability, and suggests a set of hypotheses for further analysis. These hypotheses will be tested in the case studies to be undertaken in the context of the GDN project on "Understanding Reform."

The following section highlights the key changes in the external environment and the corresponding reforms across regions. Section III compares the reform experiences of Latin America and the Middle East in the last two decades. Section IV provides a selective review of the theoretical explanations of reform variability in response to changes in the external environment. Section V concludes with suggestions for conducting country case studies.

Before moving to the next section, it is important to clarify what is meant by reform and its likely outcome, especially since there is confusion about both. Indeed, during 2002 newspapers around the world were packed with obituaries of structural reforms or "the Washington Consensus," a phrase created by John Williamson (1990) to mean a summary of the lowest common denominator of policy advice addressed by the Washington-based institutions. The position in favor of structural reforms is based on the belief that they will create a more stable macroeconomic order, increase the economic efficiency in the market place and provide the basis for improved social justice. The position against structural reforms focuses on the 1990s crises and builds a case against opening capital markets. Critics also claim that such reforms led to a deterioration of income distribution, but the evidence that reforms worsen income distribution within countries outside of Eastern Europe is not consistently supported (see, for example, Deininger and Squire, 2002).

The confusion is unfortunate. The Washington Consensus began with the proposition that the inflation caused by lack of fiscal discipline is bad for income distribution. And most reforms included in the Washington Consensus had an a *priori* pro-poor bias. For instance, redirecting public expenditure toward primary health and education helps build the human capital for the poor. Moreover, as stated by John Williamson (2000), “tax reform can be distributionally neutral or even progressive. A competitive exchange rate is key to nurturing export-led and crisis-free growth and is hence in the general interest, including those of the poor. Trade liberalization, certainly in low-income, resource-poor countries, tends to be pro-poor because it increases the demand for unskilled labor and decreases the subsidies directed to import-competing industries that use large volumes of capital and employ small numbers of workers, many of them highly skilled. Foreign direct investment helps raise growth and spread technology, provided that protection is not excessive. (...) The impact of privatization depends very much on how it is done: the sort of insider-voucher privatization that occurred in Russia allows the plunder of state assets for the benefit of an elite, but a well-conducted privatization with competitive bidding can raise efficiency (…) with benefits for all, including the poor. Deregulation in general involves the dismantling of barriers that protect privileged elites (even if some of them, like trade unionists, have difficulty thinking of themselves as an elite), and hence there is a strong presumption that it will be pro-poor.” Of course, the impact of reforms depends on the way they are implemented and on the external environment. Successful financial liberalization is particularly sensitive to the way in which it is implemented and on the state of the world economy. The welfare impact of privatization depends on the transparency of the process, market structure and regulatory regimes of monopolies (Galal et al. 1994). And foreign direct investment is not beneficial if it is concentrated in protected industries and devoted to satisfying local demand.

If reforms are potentially pro-poor, there are also good reasons to suspect that they can remove blocks on the path to sustainable growth. Sachs and Warner (1995) use trade policy as a measure of economic management and present strong evidence showing that open economies (i.e., non-socialist economies with little protection) outperform closed economies. But other economists’ interpretations vary regarding the evidence on the consequences of reforms in different regions. Pro-reform economists point to huge gains in combating poverty in China and India as proof that reforms work (see, for example, Dollar and Kray, 2002). Critics of reform claim that these countries made progress because they did not embrace the

Washington Consensus. Taylor (1991) argues that there are "no great benefits (plus some costs) in following open trade and capital markets strategies (...) Development strategies oriented internally may be a wise choice."

Reform critics make some valid points. It is true that administrative reforms could hurt the interest of public employees, privatization could negatively affect the employees of public enterprises, reform of public sector pensions would reduce privileges of public employees, and trade liberalization would be detrimental to industrialists in the import substituting sectors. It is also true that the removal of food subsidies in the name of fiscal prudence, the adoption of cost recovery of social services to make them self-financing, and lowering corporate taxation to promote investment could hurt the poor and benefit the rich. But all reforms are costly to someone. Therefore, their merit should be judged by whether they make society better off, and whether the winners are made to compensate the losers. The additional argument in favor of reform is that without it, progress for all is very unlikely. With reform, the probability of making progress increases substantially.

In light of the above discussion, it is assumed in the rest of the paper that reforms are at least necessary for rapid and more equitable growth as well as for alleviating poverty. Details regarding how reforms can be made to achieve these objectives are not addressed in this paper, given the focus on understanding reform itself in light of changes in the external environment.

II. Broad Patterns of Encounters with Reform

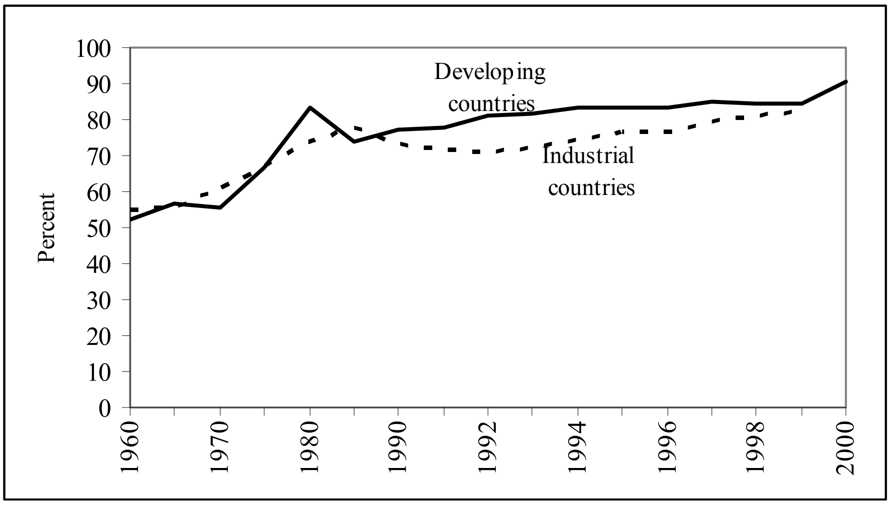
Two observations have characterized the global economic scene in recent decades. The first is a marked increase in global economic integration; the second is an intensified market-oriented reform effort in developing countries. Below is a sketch of the major changes in both, which supports the point that not all regions have responded to changes in the external environment similarly.

Changes in the External Environment

Available data show that the world has become more interdependent than ever before. Driven by technological developments in communications and transportation, the collapse of communism and falling trade barriers, exports and imports relative to GDP increased sharply after 1972 (Figure 1). Increased trade is seen in both developed and developing countries. Trade expansion has been steady, despite recent crises in East Asia, Russia and Latin

America. This wave of economic integration is further distinguished from previous episodes by (i) a rise of intra-industry trade; (ii) an increase in production across nations; (iii) the emergence of new countries with high trade-GDP ratios; and (iv) an increase in exports of manufactured goods from low- to high-wage countries (Krugman, 1995).

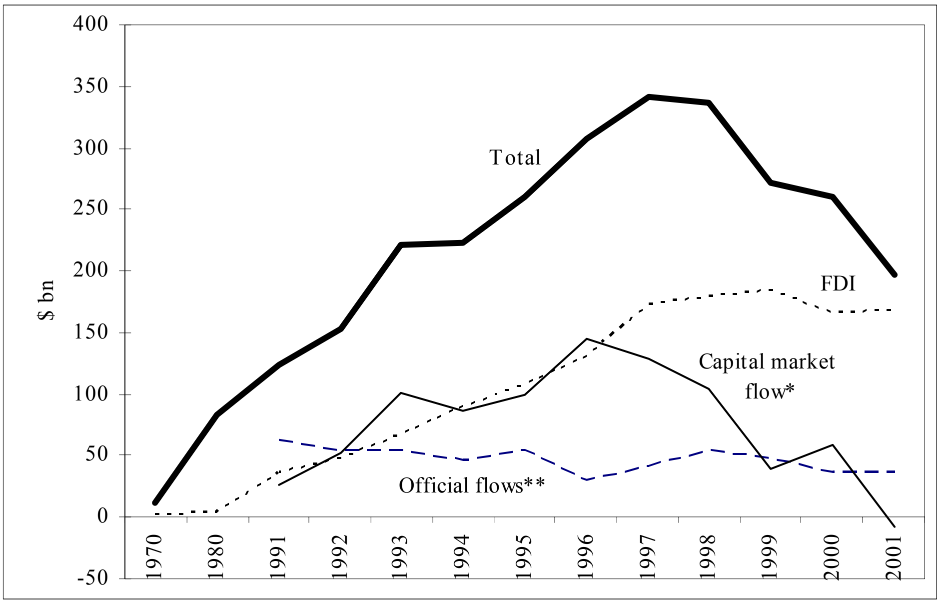
Figure 1: Trade* in Goods and Services as Share of GDP, 1960-2000



* Exports plus imports. The share of trade in GDP for developing and industrial countries is calculated as the simple average of the said indicator for individual countries classified as developing and as industrialized countries, respectively. Country classification by developmental stage is based on the *Human Development Report* 1999. Developing countries include Eastern Europe and the Commonwealth of Independent States.
Source: Calculated from World Bank. 2002. *World Development Indicators CD ROM*.

Trade expansion has been accompanied by significant capital mobility, especially since the 1980s (Figure 2). Although this trend has subsided somewhat since 1997, the decline was concentrated in portfolio investment. Otherwise, foreign direct investment has remained steady, so have official flows. Although a similar level of capital flows to GDP was seen one hundred years ago, Fishlow (1985) notes that earlier capital flows were received by governments in colonized countries, and were devoted to a narrow range of infrastructure projects. Today, the nature of borrowers and investment allocation is different, involving the private sector and non-infrastructure projects.

Figure 2: Net Long-Term Flows to Developing Countries, 1970-2001



Notes: Data for 2000 are preliminary. Data for 2001 are estimates.
* Capital market flows include portfolio investment and debt flows in the form of bank lending and bond finance.
** Concessional and non-concessional official flows.
Source: World Bank. *Global Development Finance*, various issues.

Capital flows are of course a double-edged sword. On one hand, they supplement low domestic savings and enable developing countries to grow rapidly. FDI further enables these economies to access advanced knowledge about production techniques, management practices, and sometimes export markets. These benefits are as important for development as physical capital itself. On the other hand, capital flows can be costly. They complicate macroeconomic management, increase the risk of contagion and expose countries to sudden capital flight, with potential significant losses of output and employment. The net benefits depend on whether countries adopt policies to mitigate these risks and maximize the gains.

It is also important to remember that the current episode of world economic integration is not new. Historically, the ratio of trade to GDP grew during the period 1820–1913, followed by a period of low integration from 1913–1950 due to the two world wars and protectionism during the Great Depression (Table 1). From the 1950s until the 1970s, industrial economies led the integration process to reach the level of integration that was prevalent at the turn of the century (Krugman, 1995). Since then, global economic integration has increased to unprecedented levels. In view of the historical reversal of integration, a legitimate concern is whether the current episode of economic integration is likely to be reversed.

Table 1: Globalization as Share of Exports in GDP, 1920-1995

Years	World Merchandise Exports/GDP (%)
1820	1.0
1870	5.0
1913	8.7
1929	9.0
1950	7.0
1973	11.2
1992	13.5
1995	16.0

Source: ILO. 1999. *Working Party on the Social Dimensions of the Liberalization of International Trade.* Progress Report on the Country Studies on the Social Impact of Globalization.

In answer to this issue, it has been argued that growing world economic integration will eventually increase political pressure to erect higher trade barriers, slow immigration, and restrict capital flows (Jeffrey Williamson, 1998). The increasing number of public protests on the occasions of the WTO and G7 meetings is evidence of this backlash. However, it has been counter-argued that the probability of reversal is relatively low. Bordo, Eichengreen and Irwin (1999) make the following case: The steady expansion and cyclical stability experienced by developed countries in the post-war period provide strong motivation in these countries to favor open trade regimes. As for developing countries, most of them now have unemployment insurance schemes and could secure escape clauses in world trade agreements. As a result, they are better positioned to reduce the negative impact of increased competition from imports. Further support for opening up is gained by the growing number of exporters.

The debate over the likelihood of reversing the current wave of world economic integration is likely to persist. In the meantime, developing countries do not seem to have a choice in the foreseeable future other than to contend with increased world economic integration. The question is how have they responded to the challenge so far.

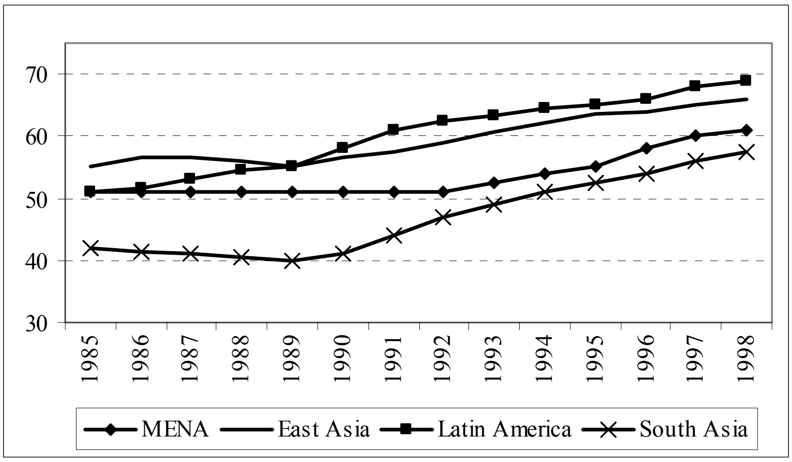
Reform Responses

Increased economic integration has created strong incentives for economic reforms in developing countries. Much of these reforms have been pursued with the support of the international financial institutions (mainly the IMF and World Bank). The pillars of these reforms, according to Williamson (1990), are macroeconomic prudence, outward orientation and domestic liberalization. The policies of the Washington Consensus, also according to Williamson (1990), are: fiscal discipline, public expenditure quality, tax reform, interest rate liberalization, competitive real exchange rage, freer trade, fostering FDI, privatization, deregulation, and property rights.

To what extent have reforms been made? Several studies have attempted to answer this question, including Lora and Panizza (2002), Dicks-Mireaux et al. (1997), and Martha de Melo et al. (1996). Each of these studies emphasized a set of reform measures based on data availability, the initial conditions in the countries of interest, and the purpose of the study. For the purpose of this paper, we are interested in exploring whether reforms have been even across regions, in terms of their timing, speed and intensity. To this end, we rely on a recent study (Dasgupta, Keller, and Srivivasan, 2002), which compiled a reform index of trade policy, tax policy, real exchange rate overvaluation, and privatization. The study covers reforms in the Middle East and North Africa (MENA), East Asia and the Pacific (EAP), Latin America and the Caribbean (LAC) and South Asia (SAR) regions over the period 1985–1998. Trade policy reforms are measured by the unweighted average tariff rate. Tax policy is measured by the highest marginal tax rates on individuals and on corporations. Privatization is measured by the cumulative privatization proceeds as a ratio of GDP. Real exchange rate overvaluation is measured by David Dollar's overvaluation index (Dollar, 1992).

The results of the study are revealing (Figure 3). While all regions have undertaken some reforms, they differ widely in the timing, intensity and speed of reform. Reforms were initiated in Latin America and East Asia around 1985 and accelerated in the 1990s. By comparison, South Asia began the reform process in the late 1980s, while reforms in the Middle East picked up steam only around 1994. The pace of reform has also been slowest in the Middle East compared with all other regions. As a result, the gap between East Asia and Latin America, on one hand, and the Middle East on the other, increased by 1998. The diversity of reform efforts suggests that the reform agenda is incomplete, especially in the Middle East and South Asia. Moreover, it is clear that the changes in external environment noted earlier have not generated the same response across developing countries. Before we ask why, the next section takes a closer look at reforms in two of the four regions.

Figure 3: Structural Reform Index, 1985-1998



Source: Dasgupta et al. (2002).

II. Close Encounters with Reform: Latin America vs. the Middle East

The broad characterization of reforms that has been noted conceal rich details regarding the nature, motivation, impact and perception of reforms in different regions and countries. To highlight some of these details, the following section offers a review of the experiences of Latin America and the Middle East.

Latin America: The Economic Pendulum

Enrique Iglésias, the president of the Inter-American Development Bank (IDB), once observed that economic policy in Latin America moves like a pendulum. World War II caused economic isolation and forced import substitution policies on most countries in Latin America due to lack of external finance. The 1950s were the age, *par excellence*, of voluntarism – the belief that the state can be set to do more and do better than markets. The ideology produced modified models of imperialism such as the center and the periphery, and the creation of development banks. Growth of trade in the 1960s and 1970s opened the doors to the discussion of reforms. Land reform and changes in tax regimes became the issues of the day. The region looked for external finance and new institutions. The 1960s witnessed John F. Kennedy's invention of the Alliance for Progress, the creation of the Inter-American Development Bank, and the birth of Latin American trade agreements in search of more integration. This reform period came to an end with two oil shocks and forced the acknowledgment that globalization was necessary. The debt crisis of the 1980s led to heterodox models to stop inflation, to admiration of the Asian model, and to the beginning of liberalization, with Chile serving as a point of reference. With increased globalization in the

1990s, reforms gained a new lease on life but the decade ended in a very serious financial crisis once again.

As a matter of fact, what is common to both the 1980s and the 2000-2002 crises in Argentina, Uruguay, Brazil, and Venezuela, is the fiscal fragility underlying a growing public debt in these countries. Mussa (2002a) explains in detail that the economic issues that Argentina needed to confront during the 1990s were primarily in the areas of fiscal, monetary, and exchange rate policy. Mussa (2002b) argues that, even if relevant factors differ across individual countries and external factors have contributed to Latin America's present economic difficulties, the most important cause of the present distress is due to domestic macroeconomic weaknesses. Persistent imprudence in fiscal management during the 1990s led to a large build-up of public debt and large external financing requirements, and made many Latin American countries vulnerable to an adverse change in financial market sentiment. Yet, when dealing with financial market volatility, capital controls are not enough. Despite such controls, over-borrowing in liquid capital markets in the 1970s led to the debt crisis in the 1980s in Latin America. Even in the presence of capital controls, an emerging economy can spend beyond its means, accumulate a growing debt, and become vulnerable to external shocks. An increase in interest rates abroad, a deterioration of terms of trade, a change in investors' sentiment, or electoral uncertainty will trigger and detonate a crisis. Currently, tighter liquidity in international markets reduces capital flows to developing countries and to Latin America in particular.

Populist politicians, and many economists and political scientists attribute the most recent crisis to reforms induced by the Washington Consensus. For example, Luis Inácio Lula da Silva's victory in Brazil's 2002 presidential election was seen not only as a result of the discontent of Brazilians with reforms, but also as a symbol of a shift in public opinion across Latin America, and as a rejection of the free-market model. This view is held despite the fact that Brazil received close to US$150 billion of external capital flows from 1996–2001, hyperinflation was conquered, and infant mortality declined.

But it would be incorrect to say that voters' discontent in recent elections in Argentina and Brazil justifies the correlation of the failure to achieve growth in these countries with a failure of the Washington Consensus. Although voters in Brazil and Argentina protested against governments responsible for their economic hardship, their actions do not provide a basis for rejecting the hypothesis that reforms cause hardship. It is possible to argue that the problem was not caused by too much reform but by too little. Moreover, the economic crises in Argentina and Brazil in 2001–2002 did not derive from structural reforms but from serious policy mistakes in macroeconomic management. Financial markets in a globalized world punish such mistakes without mercy.

Turning to the nature of reforms, Edwards (1995), Lora (2001) and Lora and Panizza (2002) provide a survey of structural reforms in Latin America. Since the mid-1980s, the region has seen an important shift in its policies. For most countries, the dynamic period of reforms occurred between 1989–1994 but the rhythm and progress were different in each country. The deepest reforms have occurred in the area of trade and finance. For the region, average import tariff rates fell from 38 percent in the mid-1980s to 10 percent in the mid-1990s. Non-tariff restrictions affected 34 percent of imports in the mid-1980s compared to only 11 percent by the mid-1990s. Dispersion of import tariff rates in 1999 was also reduced to less than half the level of those in 1986 (see Tables 2 and 3).

Table 2: Average Tariffs in Latin America and the Middle East Before and After Reforms (%)

	1986	1999		1986	1999
Latin America			***MENA***		
Argentina	40	11	Algeria	27	24*
Bolivia	22	9	Bahrain	7*	8
Brazil	74	13	Egypt	43	21
Chile	20	10	Iran	21*	
Colombia	46	12	Jordan	17	16*
Costa Rica	21	3	Kuwait	4*	
Ecuador	41	13	Lebanon		10
El Salvador	23	6	Morocco	23	22*
Guatemala	50	8	Oman	3	5*
Mexico	28	10	Qatar	4	5*
Nicaragua	54*	11	Saudi Arabia	4*	13
Paraguay	71*	9	Syria	15*	21*
Peru	63	13	Tunisia	25	30*
Uruguay	36	5	Turkey	31	8
Venezuela	31	13	UAE	5	4*
Simple average	38	10	*Simple average*	18	14

* Nearest available year.
Sources:
Latin America: Lora, Eduardo. 2001. "Structural Reforms in Latin America: What Has Been Reformed and How to Measure It." Working Paper #466, Washington DC: Inter-American Development Bank.
MENA: www1.worldbank.org/wbiep/trade/TR_Data.html.

Table 3: Tariff Dispersion in Latin America and the Middle East Before and After Reforms (%)

	1986	1999		Early 1990s	Late 1990s
Latin America			***MENA***		
Argentina	21	8	Algeria	17	17
Bolivia	5	2*	Bahrain		
Brazil	30	8	Egypt	33	40
Chile	2	1	Iran		4
Colombia	17	6	Jordan		17
Ecuador	39	6	Kuwait		
Mexico	14	9	Lebanon		10
Paraguay	15	7	Morocco	30	22
Peru	26	3	Oman	8	1
Uruguay	19	4	Qatar		
Venezuela	30	6	Saudi Arabia	3	3
			Syria		
			Tunisia	10	13
			Turkey	5	13
			UAE		
Simple average	20	6	*Simple average*	15	14

* 1998

Sources:

Latin America: Lora, Eduardo. 2001. "Structural Reforms in Latin America: What Has Been Reformed and How to Measure It." Working Paper #466, Washington DC: Inter-American Development Bank.

MENA: World Bank. 2002. *World Development Indicators*.

In the area of finance, governments eliminated interest rate ceilings (Table 4), dismantled systems for targeting credit, reduced reserve requirements on commercial banks in most countries of the region, and introduced regulation and monitoring procedures to assure the soundness of the financial sector. After 1999, there was serious backpedalling in Argentina, where a dramatic financial crisis led to the introduction of a deposit freeze and interest rates ceilings, and the imposition of an arbitrary rate for exchanging dollars into pesos.

Many countries introduced reforms of their tax systems, replacing foreign trade taxes with domestic taxes, introducing value-added taxes and lowering the extreme marginal tax rates that were previously applied to personal and company income (Table 5). But tax systems in the region remain ineffective due to exclusions in tax bases and evasion.

Table 4: Financial Reforms in Latin America and the Middle East

	Year of interest rate liberalization	Capital adequacy is required in line with Basle Accord		Year of interest rate liberalization	Capital adequacy is required in line with Basle Accord
Latin America			***MENA***		
Argentina	1989	1991	Algeria		
Bolivia	1990	1995	Bahrain		
Brazil	1989	1995	Egypt	1991	1997
Chile	1985		Iran		
Colombia	1992	1992	Jordan	1988	1992
Costa Rica	1995		Kuwait		
Ecuador	1994		Lebanon		1995
El Salvador	1990	1993	Morocco	1996	1996
Guatemala	1995		Oman		1992
Honduras	1990	1998	Qatar		
Mexico	1988	1994	Saudi Arabia		
Paraguay	1990		Syria		
Peru	1991	1993	Tunisia	1996	1999
Uruguay	1985		Turkey	1980	1992
Venezuela	1989	1993	UAE		

Sources:
Latin America: Lora, Eduardo. 2001. "Structural Reforms in Latin America: What Has Been Reformed and How to Measure It." Working Paper #466, Washington DC: Inter-American Development Bank.
MENA:
For **Morocco and Tunisia:** *Financial Sector Reforms in Morocco and Tunisia* http://www.worldbank.org/fandd/english/0997/articles/060997.htm;

Interest rate liberalization for Egypt, Jordan and Turkey from: Mehrez, Gil, and Daniel Kaufmann. 1999. *Transparency, Liberalization and Financial Crises.* http://www.worldbank.org/wbi/governance/pdf/mehrez1.pdf;

Capital adequacy application dates for Jordan and Oman: Abou-Ali, Sultan. 1998. *The Status of Reforms of the Banking Sector in the Arab Countries,* http://www.worldbank.org/mdf/mdf2/papers/benefit/finance/abouali.pdf;

Capital adequacy application date for Lebanon: http://www.finance.gov.lb/main/aboutus/CountryProfile/MoentarySystem.htm; **Capital adequacy for Turkey:** Turkish Economy / The Banking Sector, http://www.turizm.net/economy/banking_sector.html.

Table 5: Maximum Business Tax Rates in Latin America and the Middle East Before and After Reforms (%)

	1985	1999		1985	1997
Latin America			***MENA***		
Argentina	33	30	Algeria		38
Bolivia	30	25	Bahrain		0
Brazil	45	25	Egypt	65	40
Chile	10	15	Iran		54
Colombia	40	35	Jordan		50
Costa Rica	50	30	Kuwait		55
Ecuador	40	25	Lebanon		10
El Salvador	35	25	Morocco	52.8	35
Guatemala	42	25	Oman		50
Mexico	42	34	Qatar		35
Nicaragua	45	30	Saudi Arabia		45
Paraguay	30	30	Syria		58
Peru	55	30	Tunisia		35
Uruguay	30	30	Turkey	40	25
Venezuela	50	34	UAE		50
Simple average	38	28	*Simple average*	53	39

Sources:
Latin America: Lora, Eduardo. 2001. "Structural Reforms in Latin America: What Has Been Reformed and How to Measure It." Working Paper #466, Washington DC: Inter-American Development Bank.
MENA*:*
1997 data for **Algeria, Bahrain, Jordan, Lebanon, Qatar, Syria, Tunisia, UAE, Yamen :**
Jalali-Naini, Ahmed R. 2000. *The Structure and Volatility of Fiscal Revenue in MENA Countrie*s. http://www.worldbank.org/mdf/mdf3/papers/finance/Jalali-Naini.pdf. **For others:** World Bank. 2002. *World Development Indicators*.
1985 data for **Morocco and Turkey:** Thirsk, Wayne (ed.). 1997. *Tax Reform in Developing Countries*. http://www-wds.worldbank.org/servlet/WDSContentServer/WDSP/IB/1997/12/01/; **for Egypt:** http://www.embassyofegyptwashingtondc.org/3.html.

Latin America led world privatization efforts in the 1990s but the process was concentrated in just a few countries. By 1995, only eight countries had privatization proceeds totaling more than 1 percent of GDP. Privatization accelerated after 1995 in such countries as Bolivia, Brazil, Peru, Argentina and El Salvador (Table 6).

Lora (2001) also notes that changes in labor policies have been limited. Only five countries carried out reforms that moderated costs of hiring and dismissing workers, and not a single country has reduced payroll taxes. Public employees and industrialists are vocal groups that can influence public opinion. Several examples illustrate this fact, for instance, in Brazil between 1991–1992, industrialists who were not in favor of the 1991 dismantling of protection (that was in effect until then) strongly opposed President Collor. Their influence helped pave the way for Collor's impeachment in 1992 on charges of corruption.

Table 6: Cumulative Revenues from Privatization in Latin America and the Middle East (% of GDP)

	1986	1994	1999		1986	1994	1999
Latin America				***MENA***			
Argentina	0	5.8	8.6	Algeria	0	0	0.1
Bolivia	0	0	19.7	Bahrain	0	0.2	0.2
Brazil	0	1.1	10.9	Egypt	0	1.0	4.7
Chile	0	0.8	3.4	Iran	0	0.0	0.0
Colombia	0	0.9	5	Jordan	0	0	0.8
Costa Rica	0	0.6	0.4	Kuwait	0	0	0
Ecuador	0	0.6	0.6	Lebanon	0	0	0.7
El Salvador	0	0	7.9	Morocco	0	2.0	8.8
Guatemala	0	0	6.4	Oman	0	0.5	0.4
Honduras	0	3.5	2.1	Qatar	0	0	0
Mexico	0	5.6	5.9	Saudi Arabia	0	0	0
Nicaragua	0	7.5	4.6	Syria	0	0	0
Paraguay	0	0.3	0.2	Tunisia	0	0.6	2.8
Peru	0	7.2	13.2	Turkey	0	1.9	2.6
Uruguay	0	0.1	0.1	UAE	0	0	0.4
Venezuela	0	3.6	5.8				
Simple average	0	2.3	5.9	*Simple average*	0	0.4	1.4

Sources:
Latin America: Lora, Eduardo. 2001. "Structural Reforms in Latin America: What Has Been Reformed and How to Measure It." Working Paper #466, Washington DC: Inter-American Development Bank.
MENA: Calculated from World Bank Privatization Transaction Database, http://www.privatizationlink.com/praccorner.cfm.

With respect to the motivation for reforms in Latin America, Lora (2000) finds strong support for the hypothesis that crises make reform viable. He finds that: (i) crises characterized by falls in real income and negative rates of growth facilitate the adoption of trade reform while inflationary crises tend to be associated with financial reforms; (ii) capital flows to Latin America have been a major engine of reform; (iii) tax reforms are more likely in countries with open trade regimes; and (iv) real devaluations of the exchange rate retard rather than facilitate trade reforms (opposed to what theory predicts). The final section of this paper revisits these findings and raises questions for the country studies to explore. But first we turn to the analysis of reforms in the Middle East.

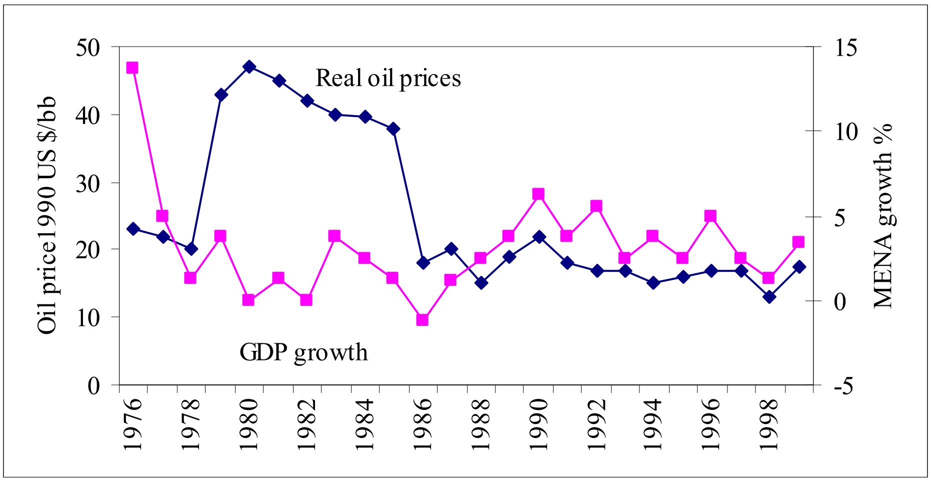
The Middle East: Lagging Behind

Notwithstanding differences in history, culture, and location between Latin America and the Middle East, economic policy in the two regions seems to have followed a similar path. Like Latin America, most countries of the Middle East followed state-led, inward-looking import substitution development policies following WWII. During the 1950s and 1960s it was believed that the state could do better than the market to achieve both growth and equity.

Beside the influence of the seeming success of socialist economies at the time, intellectuals in the Middle East found additional justification for the strategy in models like the center and periphery coming out of Latin America. By the early 1970s, however, the limits of the import substitution strategy began to show in the form of an increased burden on government finance resulting from inefficient state-owned enterprises, inflated bureaucracies, low productivity, and scarce foreign currency. The pendulum began to swing slowly in favor of reducing the role of government and increasing reliance on markets. But the shift took more than 15 years to produce tangible reforms.

Unlike Latin America, however, the Middle East did not suffer from a debt overhang in the early 1980s, recurrent capital flight, or hyperinflation. Also unlike Latin America, a group of countries in the Middle East enjoys excess capital beyond their absorptive capacity (mainly oil-producing countries) while others suffer from scarcity of capital and abundance of labor (e.g., Egypt). The main source of external shocks in the Middle East is fluctuations in oil prices. Endowed with two-thirds of the world's oil reserves, large fluctuations in oil prices change the fortune of oil-producing countries directly (e.g., Saudi Arabia, Kuwait, UAE), and to a lesser degree non-oil producing countries (e.g., Egypt, Jordan, Morocco) indirectly through workers' remittances. Figure 4 shows the relationship between oil prices and economic growth for the region. The correlation between the two variables for the period from 1976–1999 is insignificant, suggesting that other factors are also important. However, from 1988 onwards, there is a positive significant correlation (0.7 percent) between oil prices and growth rates.

Figure 4. Real Oil Price and MENA Growth, 1976-1999



Source: Dasgupta et al. (2002).

The problems facing the Middle East region seem to be fundamentally structural and long-term in nature. The region has one of the highest population growth rates in the world, averaging 2.8 percent annually between 1980–1998. In 2000, 37 percent of the population was under the age of 15. GDP growth rates were meager in the 1990s, averaging 3.4 percent, and were derived mostly from accumulation rather than productivity growth (Keller and Nabli, 2002). In addition, growth did not create many jobs, leaving the region with an average unemployment rate of 20 percent. Further, the most recent Arab Human Development Report (2002) points out that the region suffers from three deficits: knowledge, empowerment of women, and freedom. And despite repeated attempts at regional integration over the last 50 years, intra-regional trade among Arab countries remains lower than the corresponding levels of intra-regional trade elsewhere in the developing world (Galal and Hoekman, forthcoming). In 1998, for example, Arab intra-regional exports were only 8 percent of total exports compared to 22, 25, and 70 percent for the ASEAN, MERCOSUR, and APEC regional blocs, respectively.

The lack of external shocks of the Latin American variety and the long-term nature of the problems facing countries of the Middle East may have eased the pressure to initiate and rapidly move on the reform agenda. Nevertheless, there have been some reforms. The initiation of these reforms could be attributed to a host of factors, including a sharp drop in oil prices in the 1980s up until recently, the pressure to create jobs, and the inability to service external debt in countries like Egypt in the late 1980s. Reforms were often combined and supported by international financial institutions, and focused on exchange rate adjustment, fiscal prudence, freer trade and capital account, and privatization.

In the oil-producing countries, the reforms were mainly in the areas of pubic finance (in response to oil shocks) and migration in an effort to deal with incoming workers. The trade regime has not received much attention in these countries, primarily because their economies were relatively open to begin with. This is why the initial average tariff rates and their dispersion were lower in the Middle East (18 and 15 percent respectively) than in Latin America (38 and 20 percent respectively) in 1986 (Tables 2 and 3). Subsequently, the ranking of the two regions changed. By 1999, Latin American countries reduced average tariff rates to 10 percent and tariff dispersion to 6 percent, while the average tariff rate and dispersion for the Middle East only decreased to 14 percent in both instances.

Other reforms in the Middle East also lagged behind those in Latin America. With respect to privatization, the cumulative proceeds from sale amounted to 1.4 percent of GDP in the Middle East in 1999 compared to 5.9 percent in Latin America (Table 6). The maximum tax rates were reduced in both regions, but by 1999 the average came down to 28 percent in Latin America and to only 39 percent in the Middle East (Table 5). A similar pattern applies to the timing of financial liberalization and prudential regulation (Table 4), where Latin America adopted these reforms earlier than the Middle East.

Outside the oil-producing countries, reforms moved faster in Egypt, Tunisia and Jordan than in countries like Syria and Iraq. But the payoff in terms of higher growth rates proved to be out of reach. In Egypt's case, the economy grew at about 5 percent in the first seven years of the 1990s, but growth has hovered around 3 percent in the last few years. Official unemployment stood at 9 percent in 2001.

As in Latin America, the recent slowdown in Egypt prompted reform critics to question the merit of reforms and the validity of the market-oriented approach to development (Abdel Khalek, 2001). But not everyone agrees. There is no doubt that the slowdown was due in part to the loss of tourism revenues in the wake of the attack on tourists in Luxor, Egypt in 1997 and the attack on the US on September 11, 2001, along with an economic slowdown worldwide. However, others have argued that the problem is homemade, resulting from a combination of inappropriate macroeconomic management and sluggish structural reforms (El Refaie and Galal, 2000). On the macroeconomic front, during most of the 1990s the government was willing to give up higher growth and employment in return for keeping the nominal exchange rate unchanged. On the reform front, although the Egyptian economy is now more open and private sector-led than before, the policy and institutional environment remains less favorable to attracting investment and promoting exports than in competing countries in Asia and Latin America.

These are the broad stories of reform from Latin America and the Middle East. Beyond these examples, are there generalizable explanations why reforms take place in some countries, but not in others? This is the question taken up next.

IV. Competing Explanations of Variability in Reforms

Theories that explain whether reform takes place or not are based on distributional conflicts, which arise with the prospect of reform. Alesina and Drazen (1991) argue that if the costs of stabilization (or reforms) are unequally distributed and society is polarized, governments would find it difficult to stabilize (or implement reforms). The political conflict among heterogeneous groups (or the war of attrition among groups who know with certainty only their own costs) will lead to rational delays. Thus, reforms would be adopted later in countries with more political fragmentation or where small groups can use their veto power to block reform legislation. Haggard and Webb (1994) claim that fragmentation increases the obstacles to reaching compromises and contributes to the instability of governments. Thus, more fragmentation makes the approval of reform legislation more difficult than in countries with less political fragmentation.

Important elements interact with distributional conflicts and influence the outcome of reforms. Such elements include exogenous changes, like crises and the transmission of experience across countries. Drazen and Grilli (1990) extend the war of attrition model in Alesina and Drazen to show that a crisis could increase the cost of postponing reforms and thus could produce a solution to the war. For instance, a big jump in inflation could make credit subsidies, based on ceilings on lending interest rates, too big to be sustained, as it decapitalizes banks. Thus, a big jump in inflation could facilitate the liberalization of financial markets. Sachs and Warner (1995) find that in many developing countries trade liberalization has followed macroeconomic crises such as debt crises or very high inflation. In many instances, economic reform paid off in terms of increased growth. In some cases, a new economic crisis exploded after reforms as in Chile in 1982–1983, in Mexico in 1994–1995, and in Argentina in 2001–2002. In all these cases the crisis seems related to financial market liberalization in the presence of exchange rate mismanagement rather than to structural reforms.

But the immediate impact of a balance of payments crisis could also undermine reform as it makes it more difficult to find resources or policies that compensate losers in a reform process. Immediately after the eruption of the debt crisis in 1982, increased protectionism was the path that Latin American countries followed. Even Chile, the strongest supporter of free trade tripled its import tariff rates (Edwards, 1995). But by 1987–1988 it became apparent that trade and other structural reforms were badly needed. The debt crisis had a severe impact on an already weak financial sector and policymakers realized that a new approach to financial markets was needed.

Rodrik (1994) explores a competing explanation for the delay of reforms. He believes that the costs of trade liberalization are big relative to the gains. Large amounts of income need to be reshuffled among groups to compensate those suffering losses from trade liberalization, while the gains in efficiency from are small. Thus, trade liberalization is a slow process and usually takes place with other macroeconomic reforms.

As Sachs and Warner (1995) indicate, the relative power of the various interest groups to influence trade policy depends on many factors, which include: the capacity of different groups to organize politically, and the institutions for political competition. In different parts of the world, including Latin America, protectionist policies had their roots in the autarky imposed by the Great Depression and WWII. As their export markets collapsed in the early 1930s, Latin America swung from open trade to protection. In the post-war era, the import competing sectors, which faced the threat of renewed competition, added their voices to those of groups who preached in favor of state-led policies. These policies then created the expansion of bureaucratic power and the tilt of the internal terms of trade in favor of urban workers. Protectionism is favored by firms with sunken capital in import-competing sectors and workers with skills specific to those sectors.

Fernandez and Rodrik (1991) show that uncertainty about who loses from trade liberalization produces a bias against reform and toward maintaining an inefficient status quo, while Milesi-Ferreti (1991) argues that reform could also be delayed if the government is uncertain about whether it can pursue it at a low cost. Thus, one could argue that there is a spillover effect from policy choices and outcomes from other countries. A country will imitate those that pursued successful reform. Yet, one can observe a succession of crises caused by similar mistakes in different countries, which suggests that countries do not learn much from the mistakes of others.

Usually trade reform depends on other forces. For example, it could happen in combination with stabilization. The removal of trade protection would make it more difficult for domestic producers to pass on an increase in costs to consumers and keep profit margins high since they would have to compete with imported goods. Thus, a government can use the removal of import tariffs to reinforce a process of stabilization.

In contrast to Rodrik (1994), Sachs and Warner (1995) argue that the gains from trade liberalization and trade openness are significant. Trade promotes growth through many channels: increased specialization, efficient resource allocation according to comparative advantages, diffusion of international knowledge through trade, and enlarged domestic competition as a result of international competition. History offers examples. At the end of the 19th century, an open international environment allowed peripheral countries in Europe to experience rapid growth that narrowed the gap in real wages with the more advanced countries (see Aghion and Williamson, 1999). Lloyd Reynolds (1985) similarly finds that the open international economy from 1850–1914 helped promote economic growth in the developing world outside Europe and North America.

Sachs and Warner (1995) define a closed economy as one that has one of the following characteristics: non-tariff barriers covering 40 percent or more of trade; average tariff rates of 40 percent or more; a black-market exchange rate that is 20 percent or more higher than the official rate; a socialist system; and a state monopoly on major exports. They define an open economy as one in which none of these five conditions applies. They show that for most economies in the post-war period, episodes of temporary openness were characterized by sustained economic growth at a higher level than during periods of closure.

They also argue that trade liberalization establishes important links between an economy and the world and forces the government to take action on the other parts of the reform program. "Among developing countries, open trade has tended to be correlated with other features of a healthy economy such as macroeconomic balance and reliance on the private sector as the main engine of growth. To some extent opening the economy has helped promote governmental responsibility in other areas. To that extent, trade policy should be viewed as the primary instrument of reform."

Following this line of reasoning, trade liberalization is part of a larger package, not because the gains from free trade are small, but because trade liberalization plunges a country into world competition, thus forcing it to reform in other areas.

Haggard and Webb (1994) have found that international factors influence reform through a number of channels, such as the prospect of trade concessions and agreements, conditionality and ideas brought by external advisers and technocrats trained abroad. Trade liberalization can be facilitated if negotiated in steps during trade agreements.

Exchange rate devaluation could also facilitate trade liberalization as it protects the import competing sector from external competition and enhances export competitiveness.

According to Edwards (1995), "a large devaluation should constitute the first step in a trade reform process. Maintaining a depreciated and competitive real exchange rate is also important for avoiding an explosion in the growth of imports and a crisis in the balance of payments. Under most circumstances, reducing the extent of protection tends to generate a rapid and immediate surge in imports; however the expansion of exports usually takes some time."

Rajan and Zingales (2002) argue that opening the economy is central in promoting other reforms. They note that incumbents (established industrial firms and domestic financial institutions in an economy) oppose financial development because it brings competition. Rajan and Zingales' theory predicts that incumbents' opposition will be weaker when an economy allows both cross-border trade and capital flows.

In times of stability, industrial incumbents can finance new projects out of earnings without accessing external capital markets and can use the collateral from existing projects to borrow. Thus, they do not ordinarily need a sophisticated financial system to obtain funds. The better disclosure rules and enforcement of a developed financial market reduce the relative importance of incumbents' collateral and reputation, allowing newcomers to compete away profits.

A similar argument applies to incumbent financiers. While financial development provides incumbents with an opportunity to expand their activities, good disclosure and enforcement also destroy their advantage, which is "relationship-based". The incumbent financier's old skills become redundant while new skills such as credit evaluation and risk management become necessary. In sum, a more efficient financial system facilitates entry and thus leads to lower profits for incumbent firms and financial institutions. Incumbents could organize against financial development and rely on other groups, such as trade unions, as there is evidence that unions share in rents from industrial concentration.

Openness might spur financial development. On one hand, cross-border capital flows alone (without open trade) are unlikely to generate entry, making the industrial sector more competitive. On the other hand, if the economy is opened to foreign trade, incumbent industrialists have to compete with foreign producers and will want access to external finance, which requires reforms that improve transparency. Openness in both the industrial and financial sectors may be necessary for the pro-finance forces to coalesce. Industrial incumbents, with depleted profits and the need for new investment will need funds to meet their challenges. With free cross-border capital flows, the government's role in directing credit will become more circumscribed and its role in the financial sector will diminish. Then firms themselves will push for financial development. However, as the domestic financial sector loses some of its biggest clients to external financial institutions, they will face new and riskier clients. Thus, financial institutions will have an interest in pressing for improved disclosure, better contract enforcement (i.e., financial development). In summary, Rajan and Zingales' theory implies that incumbents are most able to coordinate opposition to financial development when cross-border capital and trade flows ebb, but not when they are vibrant.

Rajan and Zingales (2002) also provide empirical evidence that supports their theory. Their results suggest that financial development is positively correlated with trade openness in periods when cross-border capital flows are high, but less so, or not all, when cross-border flows are low. They conclude that there is a Catch-22 situation. Without institutional development, a developing country that opens its borders and liberalizes finance bears a high risk of a crisis. But if a country does not open its borders to capital and trade flows, finance and institutions related to transparency and enforcement in financial markets are likely to remain underdeveloped. Considering that the major cause of crises is fiscal imbalance, if a country can keep fiscal austerity despite the absence of advanced transparent institutions, then opening the economy would be beneficial as this measure will provide institutions (that are slow to develop) with an extra incentive to grow.

V. Conclusion: What Links the External Environment and Reform?

The purpose of this paper is to raise questions for investigation in country case studies that will explore the link between reforms and the external environment. As noted in the paper, empirical evidence collected for Latin America suggests that (i) crises characterized by falls in real incomes and negative rates of growth facilitate the adoption of trade reform while inflationary crises tend to be associated with financial reforms; (ii) capital flows to Latin America as whole have been a major engine of reform; (iii) tax reforms are more likely in countries with open trade regimes; and (iv) real devaluations of the exchange rate retard rather than facilitate trade reforms (in opposition to what theory predicts).

Evidence on the slow pace of reforms in the Middle East is scarce. However, broad observations suggest a number of hypotheses to explain why reforms are likely to be slow: (i) when countries face no major short term crises (e.g., debt crises, hyperinflation, or massive decline in income); (ii) when countries' problems are of a medium-term nature (e.g., unemployment and low productivity); (iii) when oil shocks occur in capital abundant countries; and (iv) lack of external commitments (involving, for example, the World Bank, IMF, or WTO).

These findings are mostly derived from econometric tests based on cross-country data and aggregated indices of reform. The country case studies could refine these findings by examining three broad questions: What motivated reforms (where observed) and what explains lagging reforms (where noted)? What was the link between reform elements? Finally, what was the outcome of these questions and the nature of the debate in the country under investigation? In the process of answering these questions, the authors of the country studies could draw on the hypotheses presented here. In addition, it would be useful to explore: Which crises accelerate or delay reform? Why devaluations could retard reform as opposed to predictions? Have trade agreements contributed to trade reform or introduced obstacles to further multilateral liberalization? Does the causality run from privatization to inflows of external capital or from capital inflows to privatization? Are fragmented societies less open to reform?

The findings of the case studies will of course offer insights that go beyond those derived from econometric analysis of cross-country data. But case studies, by their very nature, provide unique experiences and do not lend themselves to generalization easily. Therefore, both cross-country analyses and case studies are needed to understand reform as it relates to the external environment of developing countries.

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