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The Political Economy of Trans-Pacific Business Linkages

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Abstract

The current level and future evolution of trans-Pacific business linkages are tightly linked to domestic politics in Latin American countries. Where the structure of a nation's political institutions offer credible checks and balances against discretionary policymaking, external linkages including those with Pacific partners are stronger. Future liberalization including the formation of an FTAA is more likely when new policymakers arrive in office or when existing policymakers feel strong internal or external pressure to shift the course of their trade policy. A given liberalization is more likely to be sustained when coupled with short-term observable improvement in social and economic indicators. Countries with political institutions that fail to limit policymakers' discretion are particularly sensitive to a failure to demonstrate clear and immediate results. An analysis of the potential of an FTAA to influence trans-Pacific business linkages based on these arguments suggests that adoption is far from certain and that northern and southern countries alike will have to design an agreement with particular attention to social and economic consequences in Latin American countries.

1. Introduction

The Latin American country with the strongest trans-Pacific business linkages is neither Peru with its strong historical ties to Japan, nor Mexico with its gateway to the United States market, but rather Chile with its well-consolidated democratic institutions and strong belief in the rule of law. This counterintuitive statistic highlights the important role of political institutions and political preferences in the scale, scope, and evolution of trans-Pacific business linkages. The relationship between these two variables is not, however, a simple one. The choice to open a country to foreign trade and capital flows is influenced by political costs and benefits, and the sustainability of that decision rests on the political support that liberalizing politicians engender and maintain. I use the heterogeneity provided by the Latin American postwar experience to examine the political influences on trade policy in general and on the development of trans-Pacific business linkages in particular.

While not denying or seeking to minimize the importance of shifts in the effective size of the Latin American market or the cost of trade between Latin America and NAFTA (Markusen, 2004) that may engender substantial shifts in trans-Pacific business linkages and strategies (Frischtak 2004), I seek to craft a linkage between the long-term importance of market-supporting institutions for economic growth and prosperity (Vial, 2003; Huang, Yeung, and Morck, 2004) and the political dynamic unleashed by the FTAA. Without such attention to institutional dynamics, the difficult compromises needed to secure the passage of the FTAA may be overlooked. Even if these hurdles are overcome and the FTAA is enacted, Latin American countries may squander the potential opportunity that it generates or, even worse, unleash a negative feedback that could undermine the long-term development of market supporting institutions. Huang, Yeung, and Morck (2004) provide an historical overview of the liberalization boom in ASEAN that they claim has failed to sufficiently develop local institutions in a manner that will provide the basis for long-term sustainable domestic growth. Particularly in light of the relatively poor perceptions of Latin American institutions (Vial, 2003) and the heightened attention paid to such dimensions in the aftermath of the East Asian crisis, the cautionary tale on the experience of ASEAN should highlight the importance of *ex ante* attention and focus on the process of liberalization and its dynamic impact on local institutional development.

I begin such an analysis by briefly reviewing the recent history of Latin American economic linkages, which I will subsequently draw upon in the examination of specific relationships between political institutions, external shocks and pressures, social indicators and the level, growth and sustainability of trans-Pacific business linkages. Next, I survey extant research highlighting the

importance of political institutions and political preferences for the international investment decisions of Asian multinational corporations. This discussion gives rise to specific propositions linking the development of political institutions that limit the discretion of incumbent policymakers to the depth and sustainability of a nation's external business linkages which are corroborated by the data. Having established this association among levels, I then consider the causal mechanisms through which political institutions and preferences may generate policies, which enhance business linkages such as the FTAA and, the conditions under which such policies are robust to backsliding or retrenchment. Once again, preliminary exploration of the data is corroborative. Next, I consider potential positive and negative feedback mechanisms between liberalizing policies and institutional development. Finally, I conclude by considering the likely impact on trans-Pacific business linkages of the potential passage of a Free Trade of the Americas Agreement. I highlight the countries most likely to benefit at the current time and the types of political, economic and social reforms that would enhance these potential benefits. I also suggest avenues for future research that could explore some of the proposed relationships in more detail.

2. Background

Latin American countries have on average become substantially more linked to the external environment as demonstrated by Figure 1 which plots the population weighted (top panel) and unweighted (bottom panel) average level of trade as a percentage of GDP, foreign direct investment as a percentage of GDP (both gross and net), portfolio investment (both bonds and equity) as a percentage of GDP, and foreign aid as a percentage of GDP.¹ The definition of such events is inherently arbitrary and made more difficult still by the gap between *de jure* announcements of liberalization and *de facto* occurrences particularly given the rise of non-tariff barriers and other non-transparent mechanisms for impeding such linkages. As a result, I rely upon these outcome measures of external linkages rather than the policies that may or may not give rise to such linkages.

¹ Throughout the analysis that follows, I draw from broad social science literatures in international political economy and international business to develop a richer understanding of the determinants of cross-national and intertemporal variation in trans-Pacific business linkages. While the supporting evidence is drawn from international samples of investors, trade flows, and policymakers, there is good reason to expect that the link between trans-Pacific business linkages and political institutions will mirror these broader trends. Notably, the correlation between trans-Pacific trade flows and overall trade flows exceeds 0.50. I therefore expect that the political factors which shape firm decision-making regarding foreign direct investment and the evolution of trade flows globally to be similarly operative on corresponding trans-Pacific business linkages.

An examination of these aggregate statistics highlights the dramatic expansion of external linkages in the 1986-2000 period. By contrast, the increases leading up to the Latin American debt crisis were relatively minor particularly when considering private capital flows or examined using population weighted data. The aggregate political indicators are also characterized by a substantial break in trend though the increase in democratization and checks and balances in the political system predated the expansion in external linkages by a few years. After decreases of a modest scale on an unweighted scale (top panel) and a more substantive scale on a population weighted scale (bottom panel), the political indicators plotted in Figure 2 demonstrate a marked improvement beginning in the late 1970s and early 1980s. Figure 3, which plots various types of regimes, confirms this trend showing a steady and dramatic increase in the number of stable democracies starting in 1981.

Table 1 lists notable expansions and contraction of external linkages and changes in political institutions or economic conditions at the national level for the twenty one countries in Latin America with a population greater than one million where an expansion (contraction) in external linkages is defined as an increase (decrease) of more than 5% of GDP and more than 20% of the initial level of trade or investment sustained for at least three years. I summarize these country narratives in Appendix 1. Next, drawing from literature in international political economy, institutional theory, and multinational strategy, I attempt to isolate political, economic, and social factors that help explain a country's level, change in and sustainability of trans-Pacific business linkages.

3. Political Institutions and Multinational Investment²

To successfully deploy its resources in a new country, a multinational firm must identify and contend with numerous differences between the host country market and the markets in which it has previously operated (Beamish, 1988, Hymer, 1976, Martin, Swaminathan, & Mitchell, 1998, Zaheer, 1995). Laws and regulations surrounding the acquisition of property, licensing of new businesses, hiring of workers, importing factors of production, exporting output or capital, contracting with suppliers for needed inputs, payment of taxes, government licenses and fees, and the means and feasibility of exit all vary widely across countries. Even where laws and regulations appear similar, differences in legal systems can have important differences in such relevant outcomes as the protection afforded to shareholders versus creditors or minority investors (La Porta, Lopez-De-Silanes, Shleifer, & Vishny, 1998, La Porta, Lopez-De-Silanes, Shleifer, & Vishny, 1999). A recent study that examined regulations of entry in

² The following section draws from Henisz and Delios (2002).

seventy five countries found that the official procedures and costs required to start a new business varied from as few as two procedures (Canada) taking two days (Canada) and 0.4% of average per capita income (New Zealand) to as many as twenty procedures (Bolivia) requiring up to 174 days (Mozambique) and 263% of average per capita income (Bolivia) (Djankov, Porta, Silanes, & Shleifer, 2000). The World Bank expanded and updated this study, finding Laos, Haiti and Congo (198, 203 and 215 days), and Belarus (1000% of average per capita income) to be even more hostile to entrepreneurship (World Bank, 2004). The same study found strong negative correlations between these regulatory burdens and per capita income levels across countries.

In addition to the costs of starting a new business, political, and regulatory hurdles can impose substantial costs on the day-to-day operations of an overseas subsidiary. Where policymakers can act unilaterally or have high certainty that a subservient or allied legislature and judicial branch will support their actions, future policies are likely to be more volatile in response to either exogenous shocks, changes in the identity of policymakers or even changes in the preferences of the existing policymakers (Henisz, 2004). Such changes that are the result of direct lobbying by host country competitors or incumbents are of particular concern to multinationals.

Institutional differences between nations magnify difficulties in collecting, interpreting and organizing the relevant information necessary to mount a successful entry. Markets that are similar in political structure pose less uncertainty, relatively lower costs of entry and, therefore, lower hurdle rates of return. Investors are hence more likely to enter countries where the future policy regime is relatively easy to predict (Bennet & Green, 1972, Fine, 2003, Gastanaga, Nugent, & Pashamova, 1998, Green & Cunningham, 1975, Huang, Morck, & Yeung, 2004, Loree & Guisinger, 1995, Root & Ahmed, 1978, Stobaugh, 1969, Vernon, 1977, Vial, 2003, Wei, 2000), however, as shown in samples of Japanese multinationals, this tendency may be attenuated for firms with relevant experience in the host country (Henisz & Delios, 2001) or other politically hazardous markets (Delios & Henisz, 2003b).

The impact of institutions on entry strategies can extend beyond the choice of where to invest to include the design of the subsidiary. For example, firms that perceive hazards emanating from policy uncertainty can take hazard-mitigating actions designed to shift the decision calculus of the potential expropriating government. Such a shift should seek to either raise the political and/or economic costs (lost revenue, employment, and future investment) to asset or revenue expropriation, or lower the benefits (the value of seized assets or revenue stream and the nationalist political reaction) from expropriation.

As an example of a hazard mitigating strategy, a multinational can form a partnership with a host country firm. In such a partnership, the host country firm

would also suffer in the event of an expropriation of a foreign subsidiary's returns or its assets because of the subsidiary's dependence on a continuing relationship with its parent firms for its complementary assets. In exchange for ownership in the foreign subsidiary, a host country partner provides a valuable service. Host country firms tend to use, on average, a greater percentage of domestic inputs. Because of superior information regarding the availability of, terms of, and procedures for acquiring goods in the domestic market, host country partners rely more heavily than the multinational on domestically-sourced labor, intermediate products, and trading partners. While a multinational may pay to acquire this form of local information, pursuing such a strategy raises production costs relative to domestic firms.

Depending on the size of this cost wedge, a multinational shifts some positive quantity of inputs from domestic to international sourcing (Markusen, 2003). Expropriation of the assets or revenue stream of a joint venture between a multinational and a host country partner will therefore result in a greater expropriation of assets or revenue streams owned by domestic constituents than expropriation of a solely foreign venture. As more domestic constituents are implicated in the expropriation, a partnership between a multinational and a host country firm is, on average, politically more costly to expropriate for the government than a solely foreign venture.³ Gatignon and Anderson (1988), Hill, Hwang and Kim (1990), Agarwal and Ramaswami (1992), Oxley (1999), Delios & Beamish (1999), Smarzynska (2000), and Henisz (2000) provide empirical evidence supporting this link between market entry mode choice and the degree of policy uncertainty while Delios and Henisz (2000) demonstrate that this relationship is attenuated for Japanese multinational corporations with relevant experience.⁴

In addition to the choice of entry mode, the type of assets chosen for overseas investment may vary across different institutional structures. Empirical work that has adopted a case study approach provides strong support for the hypothesis that long-lived and/or politically visible investments such as those in infrastructure sectors will be particularly sensitive to a country's institutional environment (Bergara Duque, Henisz, & Spiller, 1998, Caballero & Hammour, 1998, Crain & Oakley, 1995, Dailami & Leipziger, 1998, Daniels & Trebilcock, 1994, Grandy, 1989, Levy & Spiller, 1994, Levy & Spiller, 1996, Ramamurti, 1996, Savedoff & Spiller, 1997, Spiller & Vogelsang, 1996, Williamson, 1976). Two recent efforts to extend this logic to panel datasets in telecommunications

³ This hypothesis is strongly supported by the only available empirical study (Bradley, (1977)). The author finds that expropriation of joint ventures exclusively between foreign multinationals is eight times as likely as expropriation of joint ventures that involve local partners.

⁴ Henisz (2000) demonstrates that this relationship is conditional upon the nature of the assets under the purview of the overseas subsidiary.

(Henisz & Zelner, 2001) and electricity (Henisz & Zelner, 2002) have also found strong support for the hypothesis that political institutions that fail to constrain arbitrary behavior by political actors dampen the incentive for infrastructure providers to deploy capital and, *ceteris paribus*, yield lower levels of per capita infrastructure investment.

Another relevant dimension of heterogeneity is that between sales offices which sell imported or domestically produced manufacturing output in competition with local producers and manufacturing plants that sell exclusively or primarily to foreign customers. The former are more likely to incite political opposition whereas the latter may enjoy strong political support. Multinational firms' entry choices may therefore reflect a calculation not merely on the economics or cultural drivers of the timing of opening a local sales office but also on the political dimension as shown in a sample of Japanese multinational corporations by Delios and Henisz (2003a).

Unstable policy regimes and culturally dissimilar markets are likely associated with performance penalties as well. Carroll and Delacroix (1982) find higher mortality rates for newspapers in Argentina and Ireland during periods of political unrest. Zaheer and Mosakowski (1997) find that the failure rates of foreign firms in the financial service sector are higher in more tightly regulated and less globally integrated markets. Henisz and Delios (2003) find that in countries with greater policy uncertainty, subsidiary mortality for Japanese multinationals is higher although this effect is moderated for firms with relevant local experience. Casanova (2004) discusses the performance benefits of staying within the multinational corporation's "natural markets." Li and Guisinger (1991) find an analogous relationship between cultural proximity and survival as do Barkema, Bell, and Pennings (1996) and Barkema and Vermeulen (1997).

As political institutions influence such core elements of multinational decision-making as the choice of where to invest, how to organize that investment, and when to terminate the investment, we expect political institutions to similarly influence the development of trans-Pacific business linkages. Well-developed institutional structures that provide greater checks and balances against arbitrary or capricious policymaking should enjoy greater and more robust trans-Pacific business linkages:

Proposition 1a (P1a): Countries with stronger checks and balances against political discretion will possess stronger trans-Pacific business linkages.

Proposition 1b (H1b): Countries with stronger checks and balances against political discretion will possess trans-Pacific business linkages that are more robust to change.

Taken together the experience of the twenty one Latin American countries provides strong corroborative evidence for this pair of propositions. All the country-level measures of political institutions aggregated in Figure 2 are positively correlated with each of the country-level measures of openness aggregated in Figure 1 with correlations between the various political indicators and flows of trade and foreign direct investment ranging from 0.13 to 0.27. Further empirical analysis controlling for country size, membership in intergovernmental organizations, economic performance and the like continue to demonstrate a positive association between a country's external linkages and the development of political institutions which provide a credible commitment to investors that policies will not be changed in an arbitrary or capricious manner (Henisz & Mansfield, 2004).

4. The Determinants of Sustainable Liberalization vs. Retrenchment

Understanding the future course of trans-Pacific business linkages requires not only an understanding of the medium or long-term effects of political institutions already in place but also an understanding of the political discontinuities that trigger sudden changes in policy that make a country more or less attractive to foreign investors. Academic accounts of liberalizing reforms in Latin America (Armijo & Faucher, 2001, Biglaiser & Brown, 2003, Morley, Machado, & Pettinato, 1999, Murillo, 2001, Remmer, 1990, Starr, 2002) as well as more popular accounts of recent reversions from market oriented trade reforms in Argentina, Bolivia, Ecuador, and Peru, stress the discontinuous or episodic nature of these events. Fritschak (2004) highlights the importance of three such discontinuous regional trade liberalizations (NAFTA, Caricom, and MERCOSUR) for multinational investment patterns to date. Huang, Morck, and Yeung (2004), by contrast, provide a cautionary tale of the potentially temporary benefits of liberalization in ASEAN countries that failed to upgrade their domestic institutions. Vial (2003) emphasizes the extensive institutional development needed in much of Latin America just to reach the levels of ASEAN. Predicting the future course of trans-Pacific business linkages including future expansions and contractions therefore requires an assessment of not only the political institutions that constrain policymakers from altering current policies but also the forces that encourage them to liberalize or retrench and the feedback mechanisms between liberalization and institutional upgrading.

Liberalization. Academics examining the political determinants of trade liberalization have examined many different theoretical relationships finding generally mixed support for each depending on the sample of countries and years chosen for analysis. Does democratization generate pressures for liberalization

due to the economic efficiencies that benefit the median voter (Mansfield, Milner, & Rosendorff, 2002) or protectionism due to the greater weight attached to concentration of costs in temporal, geographic, and interest group dimensions as opposed to the more diffuse long-term benefits (Conybeare, 1991, Goldstein & Lenway, 1989, Nollen & Quinn, 1994)? Does poor economic and social performance trigger calls for protectionism by insecure polities (Magee, Brock, & Leslie Young, 1989) or provide the momentum to overcome coalitions blocking welfare-enhancing reforms (Alesina & Drazen, 1991, Drazen & Grilli, 1993, Fernandez & Rodrik, 1991, Kingdon, 1984, Nelson, 1990, Williamson, 1993)? Do a greater number of veto players in the policymaking process provide for a status quo bias in policymaking (Cowhey, 1993, Delmas & Terlaak, 2003, Goldstein, 1988, Goldstein & Lenway, 1989) or for voice for a wider array of interest groups (Frye & Mansfield, 2002)? The unsatisfying answer to even this basic set of questions linking national political institutions to trade policy is that it depends.

In order to ascertain the nature of the contingencies linking political institutions, economic, and social outcomes and trade policy, I draw upon the theoretical framework developed in Henisz and Zelner (2004). That paper develops a neo-institutional theory of the policymaking process. As political actors face multiple demands for new policies and are severely limited in the time that they can focus on the policymaking process, effecting policy change—particularly in a domain that impacts such a broad constituency as trade policy—typically requires that interest groups who favor a change in policy, for either self-interested or ideological reasons, develop a coalition with other interest groups who are only marginally affected or unaffected by the policy change. Such coalition formation is facilitated by the development of a master frame (Benford & Snow, 2000) that situates trade policy as part of a broader bundle of policies that must be altered to deal with an economic or social challenge. The resulting pressures for policy change are, however, mediated by country-level institutional structures that govern the policymaking process. Where these institutions create multiple checks and balances they create a status quo bias that requires a greater level of pressure to realize a given policy change.

Consider for example the decision to liberalize an economy that is relatively closed. Given the economic inefficiencies associated with protectionism, the existence of such a status quo policy indicates the existence of a strong political coalition that benefits from protectionism through ownership of import substituting industries or import licenses. Breaking that political coalition likely requires a change in political regime that involves a substantive change in the identity of the interest groups influencing economic policy such as occurs in the aftermath of a change in political regime or political leadership. Within an existing regime, such a change in policy could still result due to strong internal or external pressure for a policy change that overwhelms the blocking coalition. For

example, an economic crisis with steep social costs raises the costs of inaction making any policy change regardless of its short-term costs relatively more attractive (Alesina & Drazen, 1991, Drazen & Grilli, 1993, Fernandez & Rodrik, 1991, Nelson, 1990, Williamson, 1993). A crisis may serve as a “focusing event” (Kingdon, 1984: 106) that moves reform to the top of the policymaking agenda (Hoffman, 1999, Seo & Creed, 2002) by increasing the short-run costs of inaction. Only in this circumstance is radical reform such as a shift to market-oriented policies likely to occur (Astley, 1985, Jones, Baumgartner, & True, 1998, Romanelli & Tushman, 1994). Empirical support for this relationship can be found in studies of how poorly mediated distributional conflict precipitated monetarist revolutions in Chile and Britain (Fourcade-Courinchas & Babb, 2002), broad macroeconomic crises led to the adoption of market-oriented reform adoption in Latin America (Armijo & Faucher, 2001, Lora, 2000, Remmer, 1998), and the adoption of capital account liberalization (Brune & Guisinger, 2003), or privatization programs globally (Banerjee & Munger, 2002).

Alternatively, the example provided by liberalizing neighbor or the external pressure provided by conditional financing from multilateral institutions could provide the sort of reference point needed to overcome domestic opposition (Kahneman, Knetsch, & Thaler, 1986, Manuel Pastor, 1993). Prior empirical studies emphasizing policy emulation include Collier and Messick’s (1975) study of the adoption of social security systems, Knoke’s (1982) analysis of the adoption of municipal reform in the 267 largest US cities, Kobrin’s (1985) study of oil nationalization, Weyland’s (2003) study of the diffusion of pension privatization, Guler et al.’s (2002) study of the adoption of quality certification, Brune and Guisinger’s (2003) study of capital account liberalization, and Yerba’s (2002, 2003) studies of the diffusion of neo-liberal macroeconomic policies.

Another channel for international pressure to influence domestic policymaking is through the interactions between multilateral development agencies or private international lenders and their clients. Several unpublished empirical studies have found evidence of the coercive influence of multilateral development agencies on the likelihood of capital account liberalization (Brune & Guisinger, 2003), the adoption of Central Bank Independence (McNamara & Castro, 2003), and the promulgation of national right to information or transparency laws (Roberts, 2003). The notion of dependency upon international capital markets as a driver of domestic reforms has a similarly long intellectual lineage (Hirschman, 1958, Hirschman, 1968, Prebisch, 1950, Wallerstein, 1974).

Proposition 2: Liberalization of trans-Pacific business linkages is more likely in relatively closed economies

(P2a) after a regime change that enfranchises new interest groups

(P2b) after an economic crisis

*(P2c) in response to external pressure provided by
the liberalization of trading partners
the conditionality of external funding
the dependence on international financial markets.*

Returning to the context of Latin America, expansions and contractions in external linkages are closely related to change in political regime (P2a). Of the seventy episodes observed (thirty eight liberalizations and thirty two retrenchments), twenty nine were shortly preceded by a change in political regime. Interestingly, while the dominant correlation was for democratization to be associated with liberalization (fourteen cases) and retrenchment to be associated with increasing autocracy (five cases), there also existed six cases in which democratization was associated with retrenchment and four cases in which increased autocracy was associated with liberalization suggesting that changes in the composition of interest groups represented in power are crucial rather than the nature of the political regime. The tendency for a positive association between democratization and liberalization does, however, support the claim that, on average, democracies have a broader electorate (Mesquita, Morrow, Siverson, & Smith, 1999).⁵ These twenty nine regime changes constituted almost half of the 49 shifts in political regime observed in the 1960-2000 period in Latin America.

Turning next to the role of economic crises (P2b), fifty two of the seventy episodes were associated with a drop in real per capita incomes or an inflationary spike or surge in unemployment. Forty nine of 126 observed recessions; twenty six of the sixty eight observed instances of inflation increasing above then retreating below 15%; and fifteen of the twenty eight observed spiked in unemployment were associated with a shift in trade policy. There was no clear association between the incidence of crisis and the direction of change in external linkages (twenty three of the thirty two retrenchments or 72% were associated with a macroeconomic crisis as compared to thirty of the thirty eight liberalizations 79%). This finding demonstrates that it is not a question of whether poor macroeconomic performance triggers retrenchment or reform but rather than both arguments have at least some validity. Of some concern at present is the combination of poor economic and social performance and the fact that in nineteen of the twenty-one countries examined the last shift in trade policy was in the direction of liberalization.

In contrast to the corroborative evidence linking external linkages to political institutions, external shocks, external pressure in the form of trade liberalizations by prominent trading partners, lending from multilateral agencies, aid, or dependence on international financial markets due to high debt service

⁵ Thanks to Ed Mansfield for highlighting this potential explanation.

obligations appeared to play a role in influencing trade policy regimes only in the smaller countries if at all (P2c). The lack of a relationship using simple correlations may, however, fail to capture the conditionality of the underlying relationship for which other authors have found strong empirical support (Biglaiser & Brown, 2003).

Sustainability. A second question involves the political determinants of the sustainability of an adopted liberalization. Here we are considering those countries that have already liberalized and the likely political support for maintaining that policy of openness. Liberalizing involves numerous short-term costs of adjustment including reallocation of physical and human capital into those industries in which the country has a comparative advantage at world market prices. These short-term costs are tangible and immediate whereas the long-term gains of lower consumer prices seem abstract and distant. Despite the presence of some interest groups with clear interests in sustained liberalization (Rodrik, 1994) and the difficulty in unbundling trade liberalization from a broader package of economic reforms (Martinelli & Tommasi, 1997, Tollison & Willett, 1979), most interest groups and voters are likely to weigh their support for trade liberalization not on the balance of long-term gains against short-term costs but rather on the immediately observable gains against the short-term costs. Where these costs have faded into memory or are swamped by concurrent short-term gains, liberalizations are more likely to persist.

Proposition 3: The sustainability or extension of trans-Pacific business linkages is more likely

(P3a) with the passage of time

(P3b) when economic and social welfare indicators demonstrate clear progress.

Comparing medium-term economic and social progress across Latin American countries is extremely difficult due to a lack of historical comparable data, a general global upward trend in living standards, and exogenous shocks which differentially impact countries based on their natural resource endowments, trade patterns or the like. Rather than try to set some arbitrary threshold for satisfactory economic and social performance and segment countries into years in which liberalization was maintained versus reversed, I note the strong positive association between more readily observable crises and policy reversals described above and highlight that the dual of this finding is that in the absence of crises, the direction of trade policy is more likely to be maintained.

Positive Feedback Loops. This political decision calculus also gives rise to two potential feedback loops: one positive and reinforcing, the other negative and perverse. One possibility is that the government takes the additional resources

provided by trade liberalization either directly or indirectly (due to enhanced willingness to invest or lend by foreigners) and invests in public goods such as education, health care, law and order, and infrastructure. These investments lead to a positive association between liberalization and social welfare that enhances popular support for the reforms over time. Such investments in public goods have almost universal legitimacy across countries. Crafting an association between the much more controversial policy of liberalization and progress in these social indicators enhances the legitimacy of the policy reform and, thereby, its sustainability. Eventually, the reforms shift from being evaluated on the basis of their outcomes (Suchman, 1995) to being taken-for-granted or broadly accepted. This process of institutionalization creates a cognitive basis for legitimacy that further enhances the status quo bias in policymaking (Suchman, 1995, Zucker, 1987).

Proposition 4 (P4) When social and economic welfare improve, trans-Pacific business linkages may reinforce the development of political institutions.

The evidence regarding potential positive feedback effects from trade liberalization to political institutions like that of positive economic and social performance is less than conclusive. One could posit such an effect in Chile where post-1981 liberalization was accompanied by progress in social welfare indicators and real per capita income and democratization has clearly been consolidated. The simultaneous expansion of economic linkages, political rights, and social welfare in Mexico likely enjoyed positive synergies as well. El Salvador is another candidate for positive feedbacks as post-1990 liberalization has occurred alongside an acceleration of progress in social and economic welfare and the consolidation of democracy.

Negative Feedback Loops. The second possibility is that the government squanders, pilfers, or narrowly distributes the direct or indirect gains provided by liberalization. While the squandering or pilfering of resources can clearly be deemed bad policy, it may appear economically efficient to effect a more narrow distribution of resources than the polity would desire to maximize the long-term benefits for the country (Forbes, 2000). Such a distribution could, however, be perceived as illegitimate by the broad set of interest groups whose support is necessary to maintain the existing level of liberalization or expand it further. A compromise between economic efficiency and political support is therefore implicated. This compromise will tilt more towards political support in the absence of checks and balances that provide a status quo bias in policymaking particularly in democratic governments where popular interest group support is more directly related to short-term political survival.

Proposition 5 (P5) When social or economic welfare fail to increase, the risk of a reversion in trans-Pacific business linkages is greatest in countries with few checks and balances.

Of some succor in this regard is the dramatic increase in the level of checks and balances among Latin American countries over the past two decades. These political institutions that inhibit rapid changes in policies may have reduced the incidence of retrenchments in external linkages as compared to earlier periods. In the 1960s and 1970s, when many countries had autocratic or poorly developed democratic institutions, declines in economic performance or social welfare indicators frequently triggered retrenchments in trade policy. More recently, as checks and balances have developed and democracies have become more consolidated (See Figures 2-3), trade policy orientations have proven more resilient to change. After altering its orientation and political regime 4 times in 1975-91 period, Argentina has continued to liberalize over the past twelve; Brazil similarly went through four changes from 1975-89 and none in the past fourteen years; Chile altered its policy twice from 1973-83 and then remained constant for twenty years; Peru changed orientations four times in two decades and has since held a liberalization orientation for fourteen; and similar patterns can be found in many other countries where democratic consolidation occurred in the intervening period. Recent declines in real per capita incomes and social welfare in a number of Latin American countries do, however, question the limits on this relationship.

In thirteen of the twenty one countries, real per capita incomes remain below levels attained in the 1970s or 1980s. In the majority of countries, social welfare improvements are also falling short of expectations. In Bolivia, Brazil, the Dominican Republic, Ecuador, Guatemala, Honduras, Nicaragua, Panama, Paraguay, Trinidad & Tobago, Uruguay, and Venezuela social progress has been limited while Argentina, Haiti, and Jamaica social and economic indicators are in decline presenting challenges to the democratic regimes in these countries. The broad based perception of stagnation or even decline in economic and social welfare has led to the rise to office or, at least prominence, of populist leaders in a number of countries. So far, however, with the exception of President Chavez in Venezuela, these leaders are working within rather than against the political system built by their predecessors. While one could surmise that the success of these leaders' efforts to maintain an outward orientation while simultaneously providing for the pent up demands of their populations could have implications for the future of the political institutions in these countries, such hypotheses remain largely speculative at present.

5. Lessons for the Likely Incidence and Impact of the FTAA

The propositions discussed above of the relationships between external linkages, political institutions, economic, and social performance suggest that a Free Trade of the Americas Agreement neither enjoys a high probability of passage nor, should it overcome that hurdle, will it serve as a panacea for Latin American countries or their trans-Pacific business networks. With respect to the first pair of propositions, the lack of institutional development in Latin America (Vial, 2004) particularly in light of investor sensitivity to institutional capacity provides a partial explanation for the relatively low current levels of trans-Pacific business linkages and suggests that recent gains are not necessarily sustainable.

Building upon these initial insights, Propositions 2a, 2b and 2c highlight the uncertain adoption of the FTAA by Latin American countries. Coordinating passage of such extensive legislation through three countries was difficult enough in the case of NAFTA but expanding that number to over two dozen could prove intractable. Countries that vary so much in terms of their initial level of openness, their political and economic cycles and exposure to external pressure from peer countries, multilateral lenders, and international financial markets will be hard pressed to agree to a set of terms for the FTAA. Perhaps the economic gains are substantial enough to obviate the need for these exceptional triggers. The experience of the European Union highlights the potential for accord even among dozens of countries with similarly disparate conditions. The fact that the European Union began as an assembly of six much more homogeneous countries responding to clear positive external pressure to avoid a third Franco-German war and expanded in response to the rise of Japan as an external economic threat, however, highlights the limits to this analogy.

Consideration of Proposition 3 extends the skepticism by noting the likely difficulty in sustaining liberalization should the FTAA overcome the hurdle of adoption. The majority of Latin American countries are mired in an extended period of slow progress in or even degradation of economic and social performance indicators despite embarking upon expansions in external linkages that impose substantial short-term economic and political costs. One could be tempted to interpret the patterns as offering promise for long-term benefits just around the corner. Chile, the earliest liberalizer, has clearly consolidated its political reforms as well as making dramatic progress in real per capita income and social welfare indicators. A deeper inspection of the timing of the expansion of external linkages relative to economic and social gains in Chile provides a more cautious or even pessimistic appraisal of short- to medium-term trends for the region. Chile liberalized and improved per capita incomes and social welfare simultaneously thus building political support for further reforms and liberalization. Most countries liberalized five to ten years in the past and have yet to show sustained economic and social progress of the sort recorded in Chile

beginning after the taming of hyperinflation in 1976-77 and continuing with a brief albeit sharp interruption in 1983-84 for more than two decades.

The clear linkages identified between downturns or stagnation in economic and social performance indicators and reversions in external linkages give rise to substantial concern for the short- to medium-term policy regime. Negative (Proposition 5) rather than positive (Proposition 4) feedback loops appear more likely. The current wave of newly elected populist leaders in the region faces crucial pressures to deliver to their increasingly dissatisfied electorates. Only 16% of respondents in a recent LatinoBarometro poll were “satisfied with free markets.” Given the emergent nature of Latin American democratic institutions, it is possible that rather than merely triggering a policy reversal, continued shortfalls in economic and social performance could lead to regime change. Two-thirds of LatinoBarometro respondents indicated dissatisfaction with the results of democracy.

The potential for a Free Trade of the Americas Agreement if adopted to positively influence this dynamic requires responsibility from the governments of the Latin American countries and the United States. The potential economic gains of such an agreement are clear but the question of their distribution is paramount. Will the benefits accrue largely to insiders or to the nation as a whole? Will the benefits provided to Latin American countries be sufficiently large in the short-term to be perceived as fair and equitable? Given the tenuous balance of political, social, and economic forces, local governments must limit the potential for narrow segments of the population to capture a disproportionate share of these benefits.

With or without an FTAA, Latin American governments should focus on developing political and market institutions that can support sustainable economic and social development. Absent an FTAA, these governments can still undertake these reforms but will have fewer resources to do so. Thus the FTAA, like multilateral institutions, international financial institutions and Western governments, can provide resources needed to address the growing political and social tension in Latin America but it can not itself create the necessary innovations to insure a positive feedback loop. Institutional development (e.g. developing macro-level political institutions that limit the discretion of policymakers, reducing the role of state in production, improving financial market supervision and corporate governance) is of first-order concern.

Conditional on the realization of such institutional development, the impact of a potential Free Trade of the Americas Agreement on trans-Pacific business linkages will also depend crucially upon the nature of that agreement. The United States government should strive to insure a broad distribution of gains setting aside its strong bargaining power in these negotiations in recognition that while it could extract the lions share of the short-term gains, doing so would

likely lead either to the collapse of the negotiations or to the collapse of the emergent policy regimes and, potentially, political regimes that have fostered the development of openness, civil liberties, and political rights. The long-term interest of the United States government includes a prosperous and democratic Latin America. Should the United States government focus the distribution of short-term economic benefits exclusively on those countries that can provide resources of use in the War on Terror, it might well be creating a long-term threat close to home.

Should the FTAA overcome the hurdles of adoption and provide for an equitable distribution of gains within and across countries, political and institutional reforms may be consolidated and trans-Pacific linkages will likely continue to expand along with external linkages overall. An FTAA that fails to address these distributional issues, however, stands little chance of passage but even in the event of such a passage will likely be followed by a societal backlash in Latin countries that undermines much of the political and institutional development as well as the external business linkages that have been developed in recent years.

Future research should seek to statistically investigate the determinants of liberalizing or retrenching policy events and their sustainability across time. Better understanding the specific stimuli for such substantial policy changes and their durability would help policymakers and investors identify and prepare for crucial opportunities to push through liberalizing policies and hold-off pressures for retrenchment. Such analysis might also identify counter-intuitive policies that enhance sustainability such as effective education or health care expenditure which could subsequently be bundled with trade reform. The preliminary evidence gathered here suggests that such research would both inform the debate regarding the adoption of the FTAA and prepare managers for the future evolution of trans-Pacific business linkages.

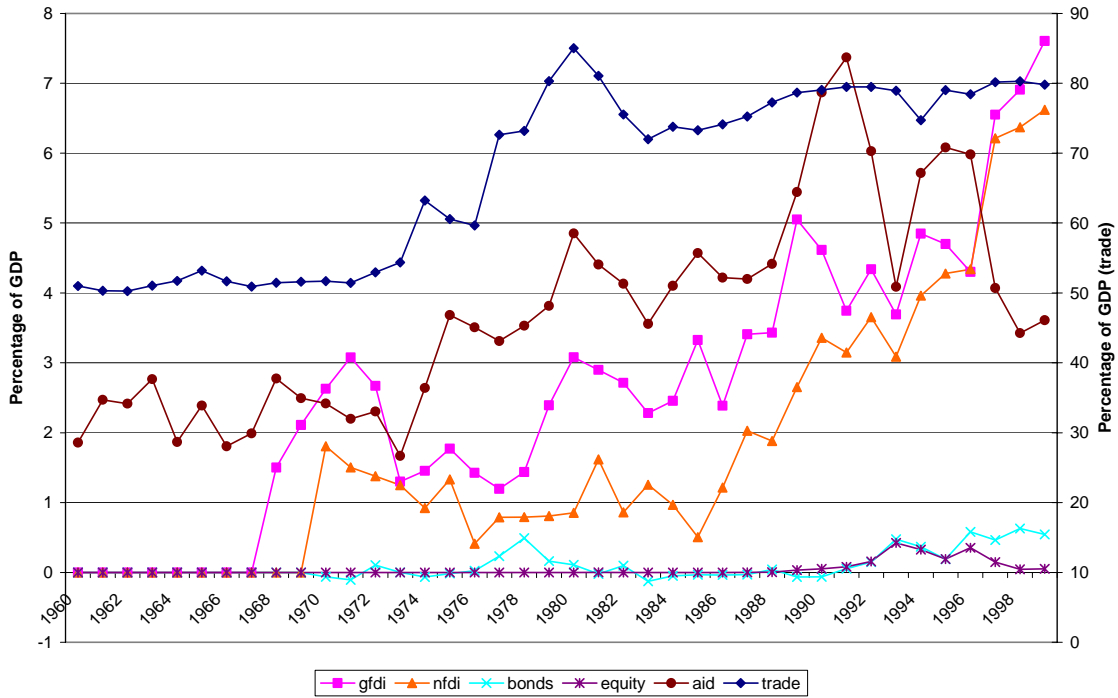
Henisz: The Political Economy of Trans-Pacific Business Linkages

| TABLE 1 : Changes in External Linkages | | | | Economic crisis | | External Pressure | | | | |
|--|----------------|---------|-------------------------|--|---|--------------------------|-------------------------------|---------------------------------|---------------------------------|--------------------------------|
| Country | Episode Type | Year | Regime Change? | Change in Real Per Capita GDP | Inflation | Unemployment | Trading partner openness | Multilateral Lending/GDP | Aid/GNP | Debt Service/GDP |
| Argentina | Retrenchment | 1963-65 | | 1962: -2.5%; 1963: -6.7% | | | | | | |
| | Liberalization | 1973-77 | 1973 -> Democracy | | | | From 32% (1972) to 45% (1974) | | | |
| | Retrenchment | 1978-80 | 1977 -> Autocracy | 1975: -1.6%; 1976: -3.6%; 1978: -5.9% | 1975: 182%; 1976: 444% | | | | | |
| | Liberalization | 1985-89 | 1983 -> Democracy | 1981: -7.1%; 1982: -6.4%; 1985: -9.0% | 1981: 104%; 1982: 165%; 1983: 344%; 1984: 627%; 1985: 672% | 1980: 2.3%; 1985: 5.3% | | | | From 6% (1980) to 31% (1985) |
| | Retrenchment | 1989-91 | | 1988: -3.9%; 1989: -8.8% | 1986: 90%; 1987: 131%; 1988: 343%; 1989: 3080% | 1986: 4.4%; 1989: 7.3% | | From 0.1% (1984) to 0.6% | From .04% in 1985 to 0.3% | From 31% (1985) to 37% (1989) |
| Bolivia | Liberalization | 1991- | | 1990: -3.7% | 1990: 2314% | | | | | |
| | Retrenchment | 1974-85 | 1964 -> Autocracy | 1968: -14.2%; 1969: 0.6%; 1970: -2.8% | 1972: 3.7%; 1973: 31.5%; 1974: 62.8% | | | | | |
| Brazil | Liberalization | 1988- | 1983 -> Democracy | 25% fall in eight consecutive years of decline | 1982: 124%; 1983: 276%; 1984: 1281%; 1985: 11750%; 1986: 276% | | | | | |
| | Retrenchment | 1974-78 | | Stagnant for four years | | | | | | |
| Chile | Liberalization | 1967-74 | 1964 -> Autocracy | | | | | | | |
| | Retrenchment | 1974-78 | | 1978: 0.81% after averaging >6% 1968-76 | | | From 25% (1964) to 49% (1977) | | | |
| | Liberalization | 1978-80 | | 1981: -6.5%; 1982: -1.6%; 1983: -5.4% | 1981: 101%; 1982: 101%; 1983: 135% | 1980: 2.8%; 1983: 4.9% | | From 0.2% (1981) to 0.6% (1984) | | |
| | Liberalization | 1984-89 | 1984 -> Democracy | 1988: -1.9% | 1986: 147%; 1987: 228%; 1988: 629%; 1989: 1430%; 1999: 2948% | 1984: 2.4%; 1992: 6.5% | | | | |
| Colombia | Liberalization | 1965- | | 1963: -0.2% | 1963: 32% | | | | | |
| | Retrenchment | 1974-76 | | 1975: -0.5% | 1973: 15%; 1974: 30% | | | | | |
| Costa Rica | Liberalization | 1976-81 | | 1980: -2.2%; 1981: -5.1%; 1982: -9.9% | 1981: 37%; 1982: 90% | 1980: 5.9%; 1982: 9.4% | | | | |
| | Retrenchment | 1982-86 | | 1985: -2.2% | | 1984: 5.0%; 1985: 6.8% | | From 1% (1983) to 3% (1985) | From 1.4% (1980) to 7.7% (1985) | From 24% (1980) to 57% (1985) |
| | Liberalization | 1986- | | | | | | | | |
| Dominican Republic | Liberalization | 1965-74 | 1965 -> Autocracy | 1964: -15.2% | | | | | From 2.2% (1964) to 8.9% (1965) | |
| | Retrenchment | 1974-83 | | 1981: -1.0%; 1983: -2.1% | 1983: 20%; 1984: 45% | | | | | From 6.3% (1974) to 31% (1983) |
| Ecuador | Liberalization | 1983- | 1978 -> Democracy | | | | | | | |
| | Retrenchment | 1970-74 | 1969-72 -> Autocracy | 1969: -0.7% | | | | | | |
| El Salvador | Liberalization | 1974-81 | | | 1974: 23.3% | | | | From 10% (1975) to 72% (1982) | |
| | Liberalization | 1981- | 1979 -> Democracy | | | | | | | |
| Guatemala | Liberalization | 1969-77 | 1964-67 -> Democracy | 1978: -6.0%; 1979: -13.1% | | | From 26% (1963) to 34% (1968) | | | |
| | Retrenchment | 1979-89 | 1977-79 -> Autocracy | <1% cumulative growth 1982-88 | Averaged > 20% per annum 1984-89 | | From 29% (1986) to 37% (1989) | | From 1.7% (1979) to 11% (1987) | |
| | Liberalization | 1989- | 1984 -> Democracy | | | | | | | |
| Haiti | Liberalization | 1962-77 | | 19% cumulative drop 1979-85 | | | | | From 0.3% (1983) to 1.1% (1985) | From 5% (1980) to 17% (1985) |
| | Retrenchment | 1977-85 | 1969-82 -> Autocracy | | | | | | | |
| | Liberalization | 1985- | 1983-86 -> Democracy | | | | | | | |
| Honduras | Retrenchment | 1962-67 | 1958 -> F. Duvalier | negative cumulative growth over 10 years | | | | | | |
| | Liberalization | 1973-80 | 1972 -> J.C. Duvalier | 1980: -4.4% after > 20% cumulative increase in 5 years | | | | | | |
| | Retrenchment | 1980-92 | | > 40% cumulative decline since 1979 | 1993: 39% | | | | From 4% (1992) to 32% (1994) | |
| | Liberalization | 1994- | 1994 -> Democracy | | | | | | | |
| Jamaica | Liberalization | ??-1980 | | 1979: -2.7%; 1980: -0.7% | 1979: 19% | | | | | |
| | Retrenchment | 1980-87 | 1980 -> Democracy | 1985: -2.4% | | | | | | |
| Mexico | Liberalization | 1987- | | | | | | | | |
| | Retrenchment | 1975-77 | | 20% cumulative decline 1971-75 | 1973: 27% | | | | | |
| Nicaragua | Liberalization | 1977- | | Additional 4% decline 1976-77 | 1977: 34% | | | | | |
| | Retrenchment | 1975- | | | | | | | | |
| Panama | Liberalization | 1961-65 | 1962 -> Democracy | | | | | | | |
| | Liberalization | 1971-74 | 1970 -> Autocracy | 3% cumulative fall 1969-71 | | | | | | |
| | Retrenchment | 1979-87 | 1979 -> Democracy | 1977: -10.6%; 1978: -28.7% | 1978: 48% | | | | | |
| | Liberalization | 1987- | 1988 -> End of State of | 29% cumulative fall 1984-87 | 1984: 219%; 1985: 681%; 1986: 911%; 1987: 10205% | 1982: 3.4%; 1987: 6.0% | | | | |
| Paraguay | Retrenchment | ??-1989 | | | | | | | | |
| | Liberalization | 1989-97 | 1989 -> Democracy | 1986: -3.8%; 1987: -15.1%; 1988: -0.5% | | 1985: 10.5%; 1989: 16.3% | | | | |
| Peru | Retrenchment | 1961-63 | | 1961: -1.1% | | | | | | |
| | Liberalization | 1976-80 | | | | | From 27% (1972) to 40% (1976) | | | 17 |
| | Retrenchment | 1980-83 | | 1981: -6.5%; 1982: -5.8% | | 1981: 5.6%; 1982: 8.3% | | | | |
| | Liberalization | 1983- | | | | | | | | |
| Peru | Retrenchment | 1961-65 | | | | | | | | |
| | Retrenchment | 1968-71 | 1968 -> Autocracy | 1967: -2.4% | 1967: 19% | | | | | |
| | Liberalization | 1976-80 | 1977 -> Democracy | 1975: -0.8%; 1976: -2.3%; 1977: -2.4% | | | | | | |
| | Retrenchment | 1980-87 | | | | | | | | |
| Peru | Liberalization | 1989- | | 1987: -10.5%; 1988: -10.8% | 1987: 667%; 1988: 3399%; 1989: 7482% | 1986: 4.8; 1988: 7.9% | | | | |

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| | | | | | | | | | |
|-------------------|----------------|---------|-----------------------|---|----------------------|-------------------------|--|--|---------------------------------|
| Trinidad & Tobago | | | | | | | | | |
| | Retrenchment | 1965-67 | 1966 --> Democracy | 1964: -0.5% | | | | | From 0.1% (1962) to 2.3% (1965) |
| | Retrenchment | 1980-85 | | | 1980: 17.5% | | | | |
| | Liberalization | 1987-97 | | Cumulative 18% drop 1983-87 | | 1981: 10%; 1987: 22.3% | | | |
| Uruguay | | | | | | | | | |
| | Retrenchment | 1960-64 | | | | | | | |
| | Liberalization | 1973-77 | 1971-74 --> Autocracy | 1970: -0.6%; 1971: -1.3% | 1971: 76%; 1972: 97% | | | | |
| | Retrenchment | 1977-82 | | 1977: 0.9% | | | | | |
| | Retrenchment | 1983-88 | | 1981: -10.3%; 1982: -10.8%; 1983: -1.8% | | | | | |
| Venezuela | | | | | | | | | |
| | Liberalization | 1972-74 | | 1970: -1.9%; 1971: -2.1% | | | | | |
| | Retrenchment | 1974-83 | | 1973: -1.4%; 1974: -0.7% | | | | | |
| | Liberalization | 1983-90 | | 25% cumulative drop 1976-84 | | 1981: 7%; 1983: 13% | | | |
| | Retrenchment | 1990-95 | | 1988: -11.0% | 1988: 84% | 1987: 7.3%; 1989: 10.4% | | | |
| | Retrenchment | 1997- | | 1997: -1.8%; 1998: -7.9% | 1995: 100% | 1992: 6.7%; 1998: 14.9% | | | |

Figure 1: Openness Unweighted Openness Measures



Population Weighted Openness

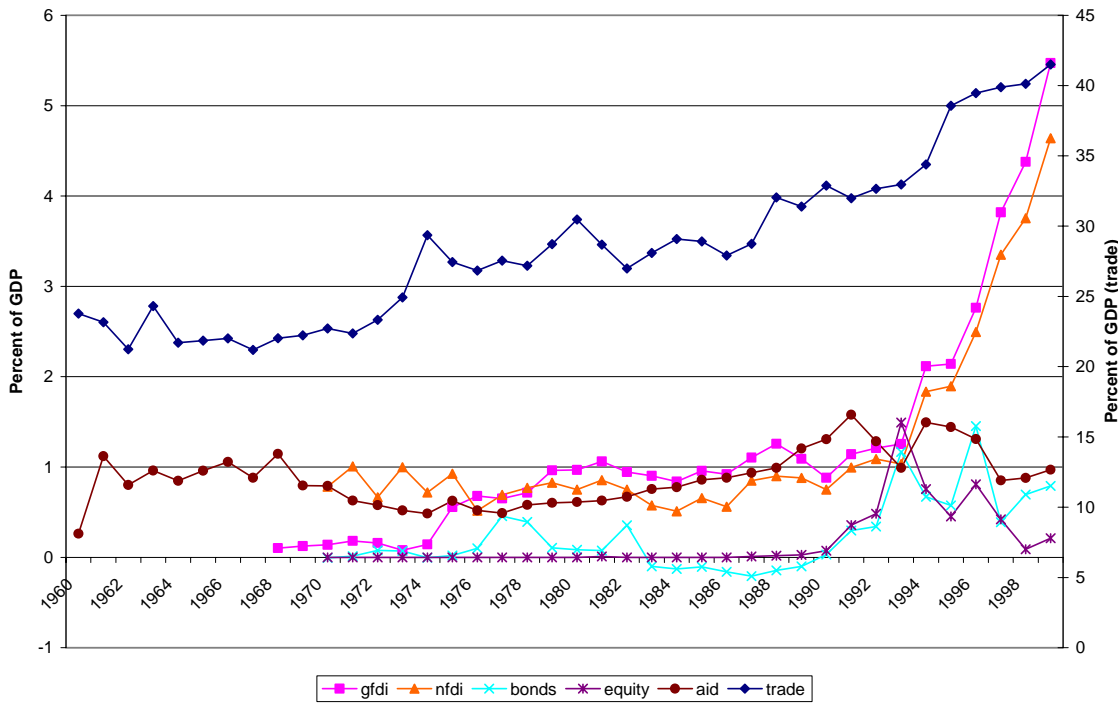


Figure 2: Political Institutions

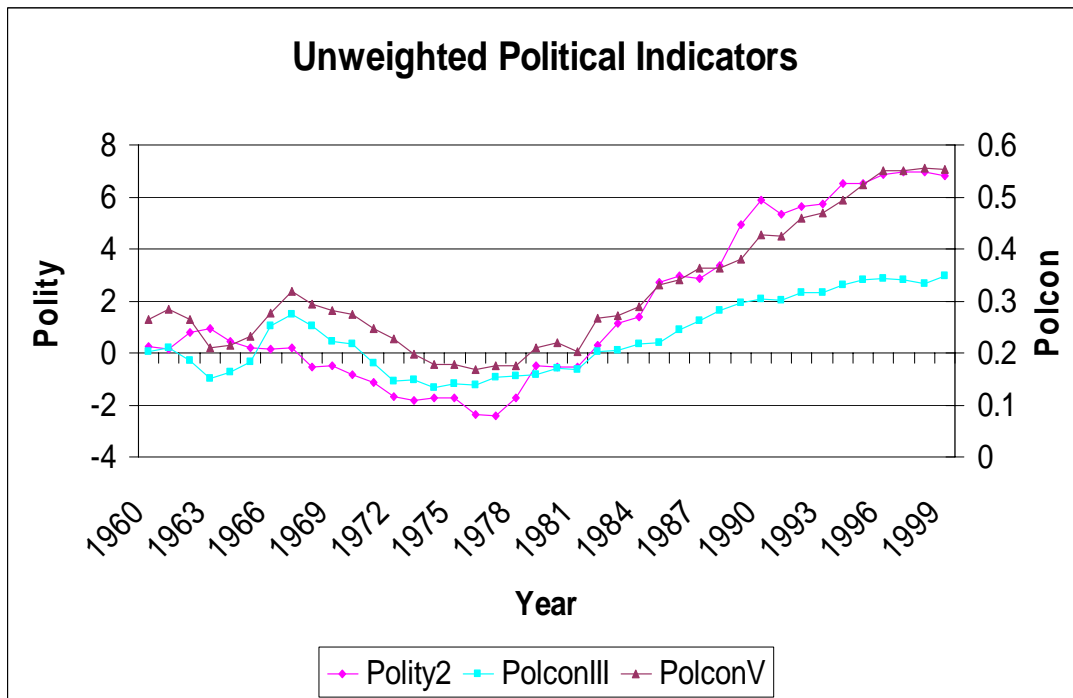
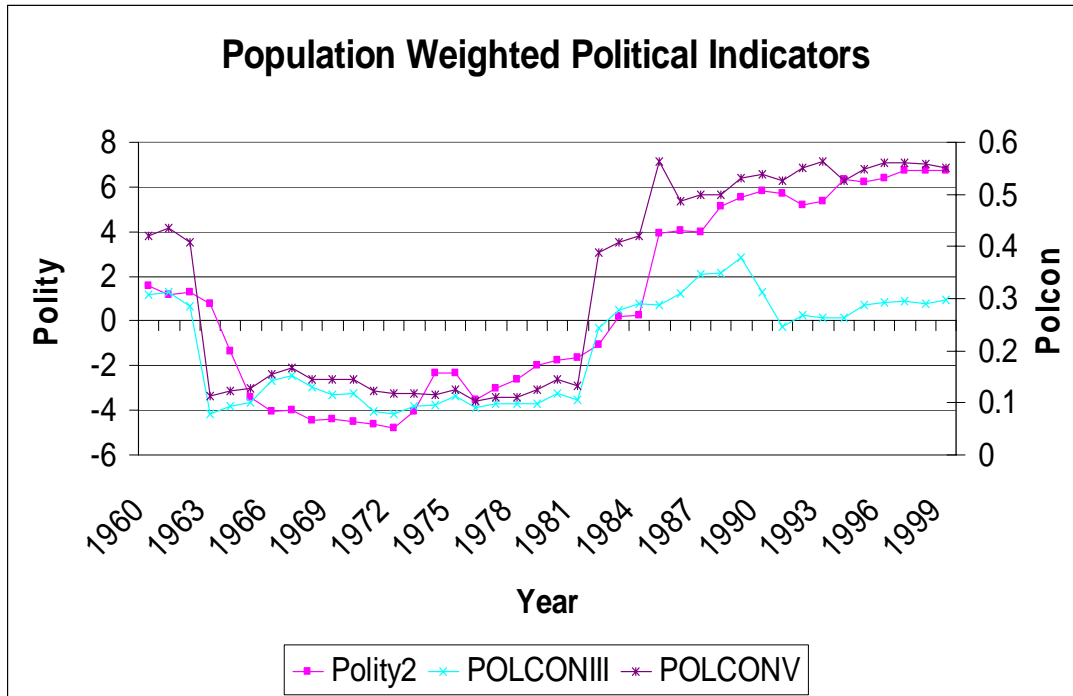
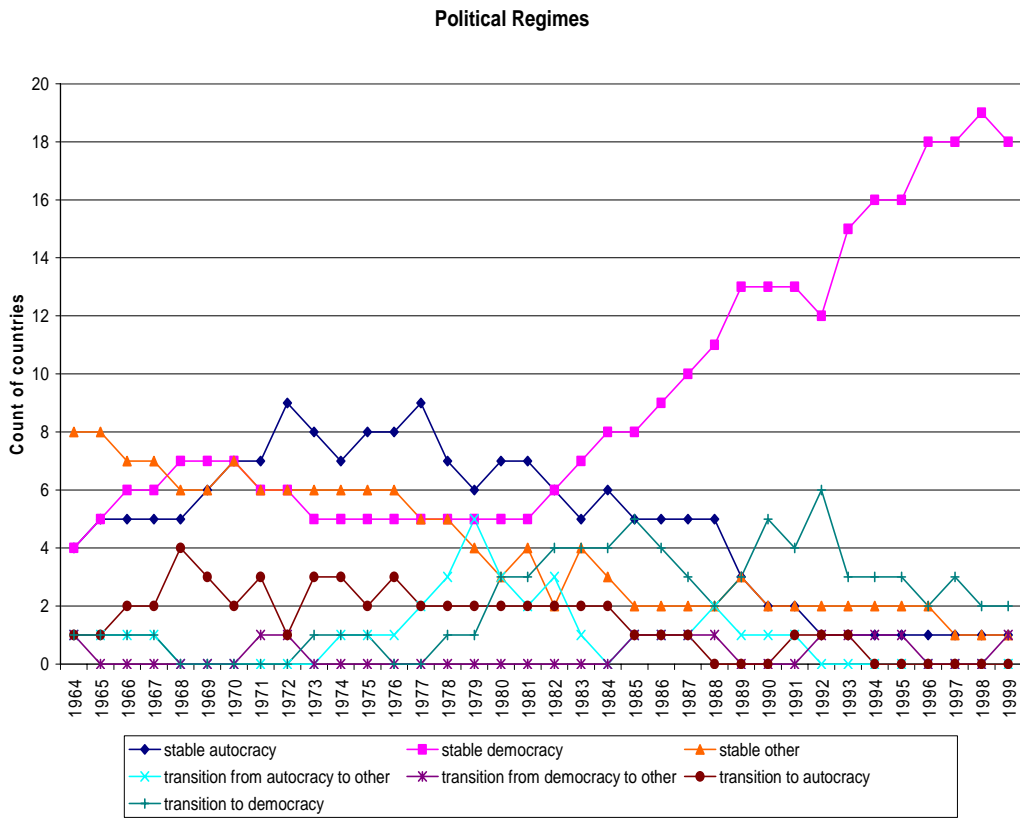


Figure 3: Count of Regimes



Colophon

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Appendix 1: Country Narratives

- *Argentina.* Argentina experienced its first retrenchment after the recession of 1962-63. Then followed a decade of relative stability in external linkages under the military governments of 1966-73 during which time real per capita incomes soared 60%. Subsequently, Argentina experienced fitful liberalizations episodes under the brief democratic regime of the Perons from 1973-1976 and after the return of democracy under Raul Alfonsin in 1983 that each ended in hyperinflation and contributed to a steady decline in real per capita income. Despite the more than 25% reduction in real per capita income, there was no substantive reduction in external linkages perhaps due to the numerous checks and balances that characterized the relatively stable Argentine political regime. After inflation peaked over 3000% in 1989, the new Argentine government of Carlos Menem launched a more sustainable economic reform program that simultaneously tackled inflation and committed the economy to openness particularly with its partners in MERCOSUR. Within a decade, real per capita income had increased by over one third.
- *Bolivia.* Political instability and regime change in the 1968-71 period ended in hyperinflation and the reversion of prior progress in the establishment of external linkages. After the taming of hyperinflation in the late 1980s, external linkages again began a steady upward trend. During the next twelve-year period, real per capita income increased by over 20% but remained more than 10% below their 1979 peak and 5% below the previous peak of 1968. The onset of a relatively mild recession in 1999 triggered a partial reversion in external linkages despite the development of strong checks and balances within the policymaking structure perhaps because economic and social progress had been relatively moderate under the democratic regime.
- *Brazil.* Beginning shortly after the consolidation of autocracy in Brazil in 1965, a near decade period of steady growth and increased external linkages contributed to a more than doubling of real per capita income. As growth slowed in the mid-1970s, external linkages were reduced and entered a period of volatility. The sharp recession of 1981-83 culminated in a regime change and the onset of democratization in 1984 under Jose Sarney. Brazil then began an expansionist policy that briefly improved economic performance but ultimately culminated in hyperinflation and a two decade low in external linkages in 1989. Another expansionist though less severe cycle characterized the leadership of the National Reconstruction leaderships of Presidents Fernando Collor and Itamar Franco and ended in 1994-95 with the election of Fernando Cardoso of the Brazilian Social Democratic Party at which time a sustained period of growth in incomes and external linkages under low

inflation began. External linkages did not revert during the 1998-99 recession perhaps aided by the strong checks and balances in the new Brazilian political system and a honeymoon effect that remained from the slaying of inflation. The steep rise of unemployment and increase in male and female mortality rates, however, called into question the sustainability of these policies in the medium term.

- *Chile*. Chile underwent a regime change in 1973 replacing the democratically elected President Allende with the military junta of General Pinochet. After a rapid liberalization of the economy including an expansion of external linkages, a hyperinflationary episode followed which triggered a collapse in real per capita income growth as well as a pause in the growth of external linkages. Rapid growth in external linkages resumed after the passage of the 1981 constitution, which called for a return to democracy and survived the steep 1983-84 recession. Per capita income grew at steady and sustainable rates since 1985 leading real per capita income to more than double in twenty years. Since the inception of democracy, external trade linkages have trended slightly downward through capital linkages have soared.
- *Colombia*. Colombia exhibits relatively steady democratic institutions, per capita income growth and moderate inflation throughout the 1960-98 period and steady growth in trade linkages after 1965. Liberalization survived the mild 1976 and 1983 recessions as well as the more severe 1998-99 recession perhaps due to the well-developed political institutions that provided a status quo bias for trade policy.
- *Costa Rica*. While the Costa Rican democracy remains among the strongest in Latin America, the inflationary episodes of 1973-74 and 1979-82 both triggered recessions and substantive pauses in otherwise uninterrupted growth of external linkages and per capita income levels.
- *Dominican Republic*. External linkages rose substantially over the 1965-74 period under the Presidency of Juan Balaguer who emerged from a military triumvirate that assumed power after the brief Presidency of Juan Bosch of the Revolutionary Party. This progress was largely reversed in 1975-83 as the rate of economic growth and progress in social indicators slowed. The consolidation of democracy and return of Juan Balaguer to power in 1987 led to another burst of growth in external linkages that survived the steep 1989-90 recession that tamed inflation and continued through 2000 and led to a 50% increase in real per capita incomes over that period. Of some concern, however, is the dramatic slowdown in the rate of improvement of social welfare indicators under the democratic regime.
- *Ecuador*. The end of a brief experiment with democracy in the late 1960s led to a surge in external linkages followed by a collapse that expanded again after Ecuador's transition to democracy in 1979. Real per capita income levels

- doubled during this period but stagnated under democratic rule as moderate inflation began to escalate. External linkages have trended slowly upwards without a significant reversion since the consolidation of the democratic regime but have not yet regained their 1975 peak.
- *El Salvador.* External linkages, per capita income levels and inflation all expanded together in the 1970s under the expansionist policies of the National Conciliation Party. The growth collapse associated with domestic unrest that escalated into civil war over the late 1970s and early 1980s triggered a collapse in external linkages and culminated in the return of democracy in 1984. The nascent democracy undertook an expansionist policy leading to a moderate spike in inflation, which peaked in 1985. By the late 1980s and more clearly in the early 1990s, per capita income growth began to accelerate, inflation was attenuated and external linkages began to return towards their peak of the late 1970s.
 - *Guatemala.* External linkages and real per capita income grew in tandem throughout the 1960s and 1970s even as democracy was undermined, human rights abuses expanded and power grew increasingly concentrated in the hands of a series of right-wing governments. The positive economic trends were broken at the onset of the Latin American debt crisis. The subsequent recession coincided with a regime change in 1986 and the new democratically elected government reemphasized external linkages and the country returned to a relatively stable period of growth in per capita income. External linkages grew throughout the period with notable accelerations in 1986-90 and 1996-2000.
 - *Haiti.* After an extended experiment with increasing autarky under Francois Duvalier, the Haitian government expanded external linkages from 1973 through the early 1980s under his son Jean-Claude Duvalier. Real per capita income levels climbed over 20% but in 1981 a reversion began that accelerated as the society crumbled (both male and female mortality rates increased steadily over the next twenty years and real per capita income fell by more than a third). The onset of regime change and eventual democratization in 1995 led to some shift in favor of external linkages and a halting of the decline in real per capita income but also an acceleration in the degradation of social indicators.
 - *Honduras.* After over two decades of steadily increasing external linkages and real per capita incomes, Honduras began a regime change towards democracy in 1981 that led to a shift in policy and a decrease in external linkages though notable improvement occurred in social indicators. In 1986, after a two-year return to military rule, Liberal President Jose Simeon initiated an increase in external linkages but also the first of a series of expansionist policies that led

- to an acceleration of inflation and no growth in real per capita income or social indicators.
- *Jamaica.* Jamaica does not present a clear relationship between political variables, economic performance and external linkages. External linkages were relatively stable during the 1960-1972 period when per capita incomes doubled and social indicators were improving dramatically. A reversion occurred during the post 1973 recession under the first administration of the People's National Party and Prime Minister Michael Manley but external linkages began to expand again in 1977 and continued to expand through a period of increasingly expansionist cycles initiated by Manley and his successors from both parties that saw inflation climb and real per capita incomes fall back to their 1960 levels. In the late 1980s and 1990s, foreign direct investment began to flow in and real per capita incomes made up one-half of their previous fall though they began to fall again after inflation was brought under control in the mid-1990s, the improvement in social indicators plateaued and political instability began to rise.
 - *Mexico.* Mexico has exhibited a steady increase in external linkages, democratization of political institutions and improvement in social indicators over the 1975-2000 period. Real per capita incomes improved by 150% from 1960-80 then stagnated for over a decade after the Latin American debt crisis as inflation soared. Since the control of inflation and the passage of NAFTA in 1995, the expansion of external linkages has accelerated and real per capita incomes have resumed their upward trend increasing by over 25% in only five years.
 - *Nicaragua.* External linkages were on a gradual upward trend in the 1960s and 1970s until the victory of the Sandinista movement and associated escalation of the civil war including American military intervention of the early 1980s triggered an economic depression. The state of emergency was lifted in 1988 and external linkages began to expand. They subsequently paused their growth as expansionist policies led to both hyperinflation and soaring unemployment. With the control of inflation and the consolidation of democracy in the early 1990s under Prime Minister Violeta Chamorro, external linkages soared and real per capita incomes began to climb though improvement in social indicators plateaued.
 - *Panama.* Only partial data on external linkages is available for Panama prior to 1980 at which time such flows were contracting precipitously, real per capital income was falling and unemployment was soaring. Beginning with the US imposed regime change in 1990, external linkages recovered rapidly as did per capita incomes.
 - *Paraguay.* External linkages were relatively stable during the Paraguayan boom of 1960-80 when real per capita incomes almost doubled. They trended

downwards in the late 1970s and early 1980s along with real per capita incomes and then began to rise rapidly particularly after the 1990 democratization and subsequent control over inflation. While real per capital incomes never reattained their 1980s peak, social indicators showed some improvement over this period.

- *Peru.* Peru's external linkages contracted steadily until the consolidation of the military regime of Juan Velasco in the early 1970s at which point they began an upward trend that lasted until the reinstatement of democracy in 1979 (itself following the recession of 1976-78) which triggered a steep downward trend in real per capita incomes and the acceleration of inflation into hyperinflation (almost 7,500% in 1989) until Fujimori's victory over the Shining Path insurgency again reversed the trend. From 1993-97, external linkages expanded dramatically and real per capita income increased by almost one third though they remain below the level attained in the 1970s. Despite a recession in 1998-99, external linkages have not declined perhaps due to the consolidation of a system of checks and balances in the country's political institutions.
- *Trinidad & Tobago.* External linkages contracted dramatically shortly after the institution of the first democratically elected Parliament in 1966. External linkages thereafter remained on a slight downward trajectory through the doubling of real per capita income to 1981 and its 20% reduction to 1987. At the nadir of the 1983-89 recession however, the first government of the National Alliance for Reconstruction under Prime Minister Arthur Robinson reversed this long-standing trend and external linkages began to climb upward. While this shift coincided with an increase in real per capita income which regained the 1981 peak, social indicators actually deteriorated during this economic boom. The trend continued under successor governments of both parties and the 1992-93 recession, highlighting the strength of the nation's system of checks and balances.
- *Uruguay.* External linkages were volatile but trending downwards as real per capita income stagnated from 1960-74. After a regime change in 1974, the new autocratic government shifted course and pursued a policy that enhanced external linkages. It abruptly shifted course during the growth pause of 1977 and again during the deep recession of 1982-85. The reintroduction of democracy in 1986 saw a return of the gradual downward trend in external linkages now with growth in real per capita incomes.
- *Venezuela.* External linkages trended gently downwards and per capita income gently upwards under the democratic regime from 1960 to 1977 with the exception of the surge in the dollar value of linkages provided by the 1973 oil shock. The economy began to deteriorate in the late 1970s and experienced negative real per capita growth for eight consecutive years. External linkages

recovered in the late 1980s and accelerated in the early 1990s though real per capita incomes were stagnant or even falling below their levels of 1960 and inflation was accelerating. The election of Hugo Chavez in 1998 triggered a reversion of external linkages and an acceleration of the deterioration of real per capita incomes.