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Foreign Trade Policy and Growth

A Comparison of Mexico and Costa Rica

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Abbreviations

CACM	Central American Common Market
CADEXCO	Cámara de Exportadores de Costa Rica; Chamber for Costa Rican Exporters
CAT	Certificado de Abono Tributario
CBI	Caribbean Basin Initiative
CINDE	Coalición Costarricense de Iniciativas para el Desarrollo; Costa Rican Coalition for Development Initiatives
e.g.	exempli gratia; for example
FDI	Foreign Direct Investment
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
IMF	International Monetary Fund
ISI	Import-substituting Industrialisation
km	kilometres
p.a.	per annum
SAP	Structural Adjustment Program
USA	United States of America
US-AID	United States Agency for International Development
WTO	World Trade Organisation

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I. Introduction

There has been a lot of work on the relation between openness and economic growth with results being ambiguous. A study done by Sachs and Warner (1995), using a sample of 135 countries, has shown that there is a positive correlation between openness and growth, e.g. that trade liberalisation fosters economic performance. The assumptions and country categorisations of this study have been criticised by Rodriguez and Rodrick (2000); they concluded that low tariff rates do not necessarily implicate higher growth rates but that tariff protection exceeding a certain level stifles growth. Dollar and Kray (cited in Santos-Paulino and Thirlwall, 2004) compared different sets of countries with each other and found out that changes in growth rates are positively correlated with the share of trade and thus greater openness has accelerated economic growth.

This essay compares the foreign trade policy of Mexico and Costa Rica. Even though both countries pursued the same policies, some differences can be found. Both implemented a strategy of import-substituting industrialisation until the serious crisis at the beginning of the 1980s, followed by a period of extensive trade liberalisation. This was due to pressure put on by the international institutions such as IMF or World Bank. While Mexico opened up its market, Costa Rica went further and lowered the import barriers. They put a strong emphasis on attracting foreign direct investments. With an average annual growth rate of 4.78 percent in Costa Rica and 4.43 percent in Mexico over the last four decades both countries achieved a strong economic growth exceeding the average of all other Latin American countries. However a positive interrelation between openness and growth could not be found in this study.

This essay is structured in four main parts. Section II of this paper deals with the fundamental comparability of Mexico and Costa Rica. Section III portrays the foreign trade policies of both countries and illustrates the main similarities and differences. The development of growth is outlined in Section IV. Section V concludes the paper.

II. The comparability of Mexico and Costa Rica

A variety of factors influence the economic performance of a specific country. Economic policy forms only a fraction of this. Trade policy in turn encompasses only a portion of these political setting levers. Therefore the exclusive examination of trade policy measurers and economic growth has to be observed critically. Even more if the comparison is based on two countries only. Political issues aside, there are a multitude of other aspects affecting the economic development. Examples of these are the geographical position, the endowment with natural raw materials, the existence of functioning institutions and the size of the domestic market, just to mention a few. Because of these multiple linkages it is hard to disentangle the effect of trade policy from other policies and influencing factors.

Mexico and Costa Rica have some similarities (in what?) but also show a couple of important differences. For instance, both are situated in Central America in a tropical climate. They both obtained their independence from the European colonial power in 1821 as a part of the viceroyalty of New Spain. Both Mexico and Costa Rica are members of the GATT and the WTO. The most important trade partner for both countries is the USA.

Some notable differences would be that the domestic market of Mexico exceeds the Costa Rican market with a population of 102 million and GDP of 626 billion USD by far. Mexico has the biggest economy in Latin America and the number eight economy worldwide in terms of exports. Costa Rica has 4 million inhabitants and a GDP of 17 billion USD. This makes it an unimportant country from a global perspective. Also the GDP per capita in Costa Rica is 4.300 USD lower compared with 6.230 USD in Mexico (World Bank, 2005a). Whilst Mexico disposes of extended natural resources like oil, gas and coal Costa Rica is dependent on importing. Mexico shares a border of more than 3.000 km with the United States, the richest nation worldwide while Costa Rica is abutting to the poor nations Nicaragua and Panama.

Despite these differences, a comparison makes sense as both countries have a great deal in common and though trade policy is only a partition of influencing factors on economic growth it is a rather important one.

III. Illustration of the Foreign Trade Policies in Mexico and Costa Rica

1. Mexico

Mexico's foreign trade policy in the last 80 years can be structured in three main phases. Even though the beginning and the end of each phase are not marked by fixed dates there are some fundamental shifts which distinguish these phases. The first phase concerns the era of import-substituting industrialisation (ISI) lasting from 1940 to 1982 followed by a phase of extensive trade liberalisation until 1994. The third and last stage marks the post-liberalisation era.

1.1. The four decades of import-substituting industrialisation

The policy of import-substituting industrialisation was firstly applied by President Lázaro Cárdenas during his presidency 1934-1940 in order to obtain the loyalty of the business sector by providing state-supplied rents through import barriers and subsidies. Another motivation to reduce the dependency from foreign trade was the fear of economic dominance by the United States (Lusztig, 2004).

The aim of an ISI development strategy is to foster industrialisation by protecting domestic manufacturers through high import barriers which hamper or obviate the market access of foreign contractors. In this uncompetitive environment domestic manufacturers are able to survive even if they would not be able to do so in an open economy. Typical measures of an ISI policy are the levy of import tariffs and the quotation of imports in combination with subsidies for domestic producers (Yarbrough, Yarbrough, 2000). The implementation of an ISI development policy is very attractive for countries which are not industrialised to a large extent. For this reason all Latin American countries have applied this strategy which is rather successful in the short-term but implies severe limitations in the long run (Lusztig, 2004). One of the most important weaknesses is the problem that a once introduced ISI policy is not easily abolished without competition. There is no incentive for domestic manufacturers to increase productivity and foster innovations in order to become competitive. The shortage of functioning institutions like well-enforced property rights, domestic competition or skilled workforce hinders the development of successful enterprises. Under these conditions import barriers and subsidies simply enabled the inefficient local industry to endure (Yarbrough, Yarbrough, 2000). The concept of infant industry protection which was developed by Friedrich List envisions a protection of domestic industries for a limited period of time to give them the opportunity to gain international competitiveness. However with the introduction of ISI in many Latin American countries no exit strategy was included in their development plans (Lusztig, 2004). Another weakness is the distribution of subsidies by the government which regularly leads to an overemphasis on symbolic national industries, such as steel or national airlines and a simultaneous disregard of the agricultural sector. Politicians regularly are unable to select the most suitable industries for subsidising especially since they are under pressure of special interest-groups. These groups also stifle the reduction of subsidies even after the failure of an import-substituting strategy becomes obvious. Instead of decreasing the dependence of imports, the ISI policy actually increases the dependence from foreign markets as capital goods have to be imported to build up capacities and to keep the production process running. In combination with lesser foreign currency income, due to a neglected exporting industry, this leads often to a steady rise in foreign indebtedness (Yarbrough, Yarbrough, 2000). Since capital goods have to be imported they are at least established, but regularly even outdated, hampering the ability to produce world-class products with sales potential in overseas markets (Lusztig, 2004).

The ISI can be structured in three phases which are clearly defined. Their occurrence in Mexico is illustrated by the following. During the first stage from 1935 to 1950 many industries producing durable consumer goods for the domestic market were founded. The lack of effective foreign competition and the easy access to subsidises and other forms of capital through national banks provided a very conducive environment. In Mexico the number of small and medium sized firms jumped from 7.619 in 1935 to 74.252 in 1950. This economic expansion fostered growth and generated further incentives for investments and thereby for a continued extension of the industrial sector. This also caused fiscal and monetary stability, which in turn drew foreign direct investments. The economic prosperity also merged in the agricultural and the service sector (Lusztig, 1996). These developments are characteristics of the second phase lasting from 1950 to 1972. To protect the domestic market from foreign competition Mexico's government not only levied high tariffs but also relied on import licenses. The percentage of imports covered by licences rose from 28 percent in 1956 to 60 percent, on average, in the 1960s to 70 percent in the 1970s (Lusztig, 2004). By 1983 100 percent of all imported goods required licenses (OECD, 1996). The development of external and domestic demand for Mexican manufactures reflects the increasing hindrances for imports. Whilst the domestic demand for goods produced in Mexico increased by an annual average rate of 71.8 percent in the 1950s, the exports only grew by 3 percent. During the 1960s these figures were 86.1 and 4 percent, respectively. With 81.5 and 7.7 percent the trend continued in the first half of the 1970s (Lusztig, 2004).

At the end of this period the first indices of the limitations of the ISI strategy became apparent: Due to the limited sales potential on the domestic market the growing rates declined, triggering a reduction of investments. Consequences included a growing obsolescence of the industrial structure and a rise of unemployment. Mexico was faced with an increasing degree of negative trade balances and a growing foreign indebtedness, as were many others countries that practiced ISI. Since the domestic industry matured in a protected environment and was not forced to be competitive in global markets, it was reliant on a continued flow of subsidises and the maintenance of import barriers. The strong lobby of Mexican manufacturers prevented the politicians from abolishing these expensive privileges even as the failure of the ISI strategy became apparent. It was also the pressure of this group which frustrated President López Portillo's plans in 1980 to sign the GATT accession agreement. This exhaustion phase lasted in Mexico from 1970 to 1982, but the effects on economic growth had been not as dramatic as in other Latin American countries. This was because of the discovery of new exploitable oil reserves in combination with the rapid rise of petroleum prices during the second oil crisis in1979 (Lusztig, 1996). Chart 1 in the appendix shows the share of oil exports of total merchandise exports. This new source of revenues also enabled President López Portillo to avoid drastic economic reforms and fostered the continued rise of government spending. The Mexican economy became extremely dependent on oil to sustain growth and public-sector borrowing which was facilitated by the global excess of capital resulting from rising oil revenues of OPEC countries (Lusztig, 2004). In the last four years of the exhaustion phase, from 1978 to 1982, the public sector deficit rose from 7.4 to 17.9 percent of GDP (Lusztig, 1996). Chart 3a in the appendix illustrates the development of the external debts and shows the steady rise of indebtedness in the 1970s with a large share of short term debt mainly provided by U.S. banks. This continuous augmentation finally resulted in Mexico’s declaration of insolvency in 1982.

As Chart 5a in the appendix illustrates the external balance of goods and services have been negative throughout the 1960s and 70s, e.g. Mexico has imported goods and services of greater value than it has exported. Neglecting export promotion is a pattern typical for an ISI strategy. It can be seen that the deficit began to increase strongly from 1978 despite of strong export growth rates due to oil sales.

It was the reliance on foreign capital and the government deficit which brought the ISI era to an end and paved the way for trade liberalisation (Lusztig, 2004).

1.2. The era of extensive trade liberalisation

This period lasting from 1982 to 1994 can be divided into two episodes. In the years leading up to 1985 the situation was determined by the urgent need to get reforms started and at the same time strong resistance against liberalisation and reduction of subsidies by several ministries; for example the Ministry of Commerce and Social Development and the Ministry of Energy, Mines and Parastate Industry who feared losing their rents (Teichmann, 2001). 1982 marked a turning point in Mexico’s recent economic history as it was the year of a devastating crisis caused by a sharp drop in petroleum prices, an increase of interest rates and an increase of inflation rates. The increase of foreign short term debts and the billing in USD worsened the effects of the global rise of interest due to a change in the fiscal and monetary policy in the

United States. Chart 2 in the appendix shows the development of the inflation rate which increased steadily since the early 1970s and reached, fostered by several devaluations of the peso since 1976, its first peak with over 91 percent p.a. in 1983. Consequences were an immense capital flight and a further destabilisation of the business environment (Lusztig, 2004).

The crisis had several effects on Mexico's economic and foreign trade policy: On the one hand the increasing government deficit obliged the administration to disencumber the national budget from inefficient public and, due to constant subsidies, private companies (Lusztig, 2004). On the other hand, even more important, the debt crisis increased Mexico's dependence on foreign funds and thereby enhanced the power of World Bank and IMF (Teichmann, 2001). The concurrence of the strong commitment of Mexico's elites toward changes and the extended power allowed the opposition of strong resistance mentioned above and to launch the "Immediate Program of Economic Recovery" (Programa Inmediato de Reordenación Económica - PIRE), which included many reforms that have been set as conditions by IMF and World Bank. In the IMF bailout agreement which was reached in November 1982, Mexico agreed to abolish exchange controls and to bring down its public debt. The World Bank insisted not only on fiscal reforms, but also on deregulation, privatisation, elimination of price controls, and liberalisation of foreign investment and trade. Furthermore, both institutions applied a policy of cross-conditionality, whereby no loans would be given unless the specifications were met (Lusztig, 2004).

As agreed by Mexico tariffs have been reduced and import licenses have been abolished from 1983 to an extent that exceeded the World Bank's recommendations (Teichmann, 2001). Table 1 in the appendix states the extent of the reduction of trade barriers. Whilst in 1983 all imports were covered by import licenses the share abated sharply to 35.1 percent in 1985 and continued to decline to 6.1 percent in 1991. The average tariff was brought down from 27.0 to 10.5 percent at the end of the decade. Regarding the trade weighted average the reduction still was considerable - from 16.4 percent in 1983 to 5.6 in 1987.

The results of the measures for macroeconomic stabilisation have only been partially successful. Due to decreasing imports and steadily increasing exports as shown in Chart 4a, the trade balance deficit transformed into a surplus from 1983 on (Chart 5a). The targets of combating inflation and revitalizing economic growth have not been reached. The inflation rate remained high and even increased dramatically to its all-time high of nearly 140 percent p.a. in 1987 (Chart 2).

The economic environment at the beginning of the second part of the liberalisation era was not only characterised by the extreme inflation, but also by a sharp decline in oil prices and the failure of materialising anticipated loans. The price of petroleum, which made up 60 percent of Mexico's merchandise exports of this year, dropped from 25.35 USD per barrel in 1985 to 11.88 USD in 1986, severely complicating the task of macroeconomic stabilisation (OECD, 1996). Trade liberalisation was seen as an effective means to bring down inflation as cheaper imports should encourage greater efficiency among domestic producers and therefore reduce the price level.

An important milestone and a strong commitment to liberalisation and to outward orientation has been the decision to join the GATT in 1986 after the accession had been primarily blocked by an influential business lobby in 1980 (Lusztig, 2004). Since that time, the reduction of import barriers proceeded with forced pace and Mexico's export profile shifted from the over-reliance on oil to an increased weight of manufactured goods, which contributed 55 percent to Mexico's exports in 1989 compared to 14 percent in 1982 (Lusztig, 1996).

Exports have been fostered through trade facilitation arrangement aimed at dealing with administrative hindrances to exports. The installation of the so-called COMPEX (Comisión Mixta para la Promoción de las Exportaciones) mechanism encompasses a number of committees that deal with complaints about government-generated barriers to export (OECD, 1996). Additionally President de la Madrid launched an export promotion program which provided preferential treatment in the areas of credit and tax relief for exporting enterprises (Teichmann, 2001). As can be seen in Chart 4a in the appendix, these measures resulted in an impressive pace of export growth from 1986 on, even though it was surpassed by the growth rate of imports, leading to a negative external balance of goods and services from 1989 on (Chart 5a).

In contrast to the immense reduction of import licenses and tariffs throughout the 1980s, Mexico began to introduce anti-dumping and countervailing duty legislation in the second half of the decade in order to compensate for unfair trade practices. Trade can be seen as unfair, for instance if either an exporter sells goods for a lower price as he does in his domestic market or if foreign governments subsidises exports (OECD, 1996). The implementation of these measures can be evaluated as a first sign of a beginning reununciation of an unconditioned trade liberalisation. This trend can be observed to continue in the 1990s.

However in the early 1990s import licenses had been abolished in all but the automotive and the agricultural sector and covered less than 2 percent of imports. The maximum tariff rate was at 20 percent with an average rate of about 11 percent. Mexico finally liberalized trade as rapidly in the six years from 1985 to 1991 as the United States did within 40 years (Lusztig, 2004).

1.3. NAFTA and the post-liberalisation era

The government's efforts for trade and investment liberalisation, together with the privatisation, deregulation and competition policy initiatives showed sound results in achieving macroeconomic stabilisation (OECD, 1996). The fiscal deficit has been brought down from 13 percent of GDP to 0.4 percent in 1993 (WTO, 1998). Inflation was reduced from over 130 percent in 1987 to under 10 percent in 1993 (Chart 2). On the other side, the current account deficit rose to 7.0 percent of GDP in 1994. It was a combination of several circumstances that initiated the peso crisis in 1994: the current account deficit and the overvaluation of the peso, adverse external events such as the rise in U.S. interest rates and some domestic political events brought the financial system on the verge of a collapse and caused the crash of the peso (WTO, 1998).

The crisis in 1994 posed a threat to Mexico's open trade policy as the government might have been tempted to reactivate protective measures to weaken the pressure on domestic companies. This was not the case because of the fact that many trade liberalisation measures were fixed institutionally through agreements such as the NAFTA and through the commitment to the

WTO. Another reason was the floating exchange rate of the peso which allowed a substantial depreciation and brought the current account back into surplus quickly (OECD, 1996).

The signing of the North American Free Trade Agreement (NAFTA) with the United States and Canada, which was activated on 1 January 1994, was the second major milestone for trade liberalisation. Mexico decided to liberalize imports following a determined schedule which envisioned the reduction of tariffs immediately on the most goods. Only for a small number of products, like motor vehicles or corn and beans, will the full liberalisation occur in 2004 and 2008 respectively (WTO, 1998). The continued protection of some goods was designed to soften the negative impact on sensitive sectors (Thorbecke, Eigen-Zucchi, 2002). The free trade agreement fostered both exports and imports which increased substantially in the following years (Chart 4a). Whilst the concluding evaluation, whether the agreement was finally positive for Mexico is controversial. It seems that the openness helped to overcome the crisis in 1994 as increasing exports to the United States backed the economic recovery (Lusztig, 2004).

In addition to NAFTA Mexico became a member of several international associations such as the Latin America Integration Association (LAIA) and the Asian-Pacific Economic Cooperation (APEC). They also signed various bilateral trade arrangements e.g. with France, Italy, Republic of Korea, Switzerland and Thailand (WTO, 1998). This continued integration in the world economy emphasizes the outward integration of Mexico despite some increases in tariffs as can be seen in Table 1.

2. Costa Rica

The progress of foreign trade policy in Costa Rica can also be divided into three main phases. Just like Mexico, and many other Latin American Countries, Costa Rica implemented a strategy of import-substitution until the early 1980s, which was followed by a period of import liberalisation combined with an intense subsidizing of exports. Since its accession to GATT 1990 Costa Rica pursues a more neutral trade policy.

1.1. Implementation of a strategy of import-substitution

Like Mexico, Costa Rica implemented a strategy of import-substitution especially for consumer goods from the 1950s, which went along with high tariff protection for consumer goods but with lower import taxes for intermediates and capital goods complemented by export taxes on those goods in which Costa Rica possessed a strong competitive advantage (Cattaneo, Hinojosa-Ojeda, Robinson, 1999). The initiated development-model was based on import-substitution on the one hand and on fostering and modernizing the traditional sectors such as banana and coffee production on the other hand (Hveem & Nordhaug, 2002). However, besides this strong trend to protectionism, there have been early attempts for regional trade integration which led to the establishment of the Central American Common Market (CACM) in 1963. The objectives of this regional alliance were "to create a common market; to promote and co-ordinate industrial development; to co-operate in monetary and financial areas; to develop an integrated infrastructure, and, to facilitate intra-regional investment." (WTO, 1995). The participating countries agreed on tariff eliminations on 94 percent of intra-regional trade and on establishing a common external tariff covering almost 80 percent of extra-regional trade with rates which belonged to the highest of the world (Hveem et al., 2002) But the members began to act individually due to inauspicious economic development and to the increasing pressure of indebtedness in the 1970s and early 1980s. They raised protective barriers even against imports from other CACM countries (WTO, 1995).

It was at the end of the 1970s as the lack of sustainability of the pursued import-substitution strategy became obvious. This was partly due to the expansion of the public sector, partly to the extensive social security program, and partly due to the inherent weaknesses of this policy discussed above, Costa Rica's budget deficit and indebtedness rose exponentially (Catteano et al. 1999; Hveem et al. 2002). Chart 3b in the appendix illustrates the development of the external total debt since 1970 consisting of short-term credits at the beginning of the 1980s. The cost of debt serving increased from a manageable 60 million in 1977 to 520 million USD in 1982 – representing 319 percent of the value of exports. This unbearable level of debt resulted in a unilateral debt moratorium in 1981, even several months earlier than Mexico's declaration of bankruptcy. (Hveem et al., 2002). The trade balance deficit, which existed since 1960 as typical for an ISI strategy, escalated in the second half of the 1970s (Chart 5b). According to Hveem et al. (2002) this was mainly due to three unfavourable developments: first, political unrest in Nicaragua in 1979 with effects on the sales of domestically manufactured goods, second the rise in oil prices and the decline in coffee prices, both leading to a decline of Costa Rica’s terms of trade from 114 in 1978 to just 69 in 1983.

The coincidence of all these negative macroeconomic developments forced the signing of a standby agreement with the IMF in December 1982. Other influencing institutions were the Caribbean Basin Initiative (CBI) founded in 1983 which was intended to secure political stability in the region by supporting economic growth (Hveem et al., 2002) and the United States Agency for International Development (US-AID) which granted financial help. The assistance of these institutions provided them influence to alter the economic policy and accelerated the renunciation of the ISI policy.

2.2. Import liberalisation and the export-led-growth strategy

In the framework of the agreement with the IMF Costa Rica pledged itself to measures intended to bring down inflation, which peaked in 1982 with over 80 percent (Chart 2), and the public sector deficit, to bring order to the foreign exchange market. In 1985 the agreement over the first Structural Adjustment Program (SAP I) with the World Bank was signed. According to Mideplan (cited in Hveem et al., 2002) Costa Rica obtained a credit of up to 80 million USD and covenanted in return policy alterations:

> The programme called for policy changes in five major areas: (1) change in policy towards export, trade and industrialization; (2) reforms of the financial system; (3) reforms in agricultural production; (4) improvement of public administration and control with public expenses; and (5) ‘economic democratization’, meaning, primarily, privatization but also access to property for new social groups. (p. 57)

SAP I included a variety of measures: the reduction of tariffs, shifting financial incentives from producers of traditional goods towards producers of non-traditional goods (e.g. through income tax reductions), continuation of a flexible exchange rate policy, abolishment of export taxes, and exemptions on import taxes used as input in the production of exportable goods (Hveem et al. 2002). In spite of some distortions due to different sources Chart 6 in the appendix shows clearly the continuous decrease of the average tariff from 1986 on. The second SAP was signed in 1989 and contained a 200 million USD loan to continue the liberalisation reforms and to diversify the scope of exports and thereby enhance the export-led growth strategy.

The transformation process was also facilitated by the huge flow of U.S. economic assistance, which summarized in 1.4 billion USD in the 1980s alone (Clark, 1995). Funded by US-AID a series of new institutions have been established, such as the Chamber for Costa Rican Exporters (Cámara de Exportadores de Costa Rica (CADEXCO)) which was intended to represent the interest of new exporters, and the Costa Rican Coalition for Development Initiatives (Coalición Costarricense de Iniciativas para el Desarrollo (CINDE)) which was devoted to foster investment in non-traditional sectors, increase productivity, employment and exports of non-traditional goods to third markets (Hveem et al., 2002). These institutions also strengthened and supported the export sector and contributed to the shift in export composition by attracting foreign direct investments and fostering the installation of free trade zones.

Promoted by these measures the export of non-traditional exports such as fresh and frozen fish and shrimp, flowers, ornamental plants, foliage, and fresh pineapple boomed. Their export value rose from 90 million in 1983 to 781 million USD in 1993, quadrupling their share of export earnings from 10 percent to 42 percent (Clark, 1995). The export was additionally encouraged by a series of mini-devaluations during the 1980s aimed at maintaining a competitive real exchange rate (WTO, 1995).

Another export promotion measure has been the Certificado de Abono Tributario (CAT) which was introduced as early as 1972 but has not been used broadly before 1983. CATs were tax credit certificates with a value of up to 20 percent of a company’s non-traditional export sales and negotiable on the national stock exchange. A product was eligible for CAT if it contained a minimum of 35 percent value added (Clark, 1995). Even though these export subsidies have helped to accelerate the transformation process, they have been a rather expensive instrument. Their share of total government expenditures rose from 1.4 percent in 1980 to an estimated 5.7 percent in 1990 contributing considerably to continuing deficits (Cattaneo et al., 1999). This fact and the extreme unequal distribution of the benefits of CAT led to gradual phase-outs of these subsidies in 1990 (Clark, 1995).

Costa Rica also made enormous efforts to attract foreign investment in non-traditional export sectors through preferential agreements, tax concessions, free trade zones, and temporarily maintaining foreign investment offices overseas. As a result of these measures, the stock of foreign direct investment (FDI) increased from 201.2 million USD in 1970 over 671.9 million in 1980 and to 1,447.1 million USD in 1990 (WTO, 1995).

As can be seen in Chart 4b in the appendix, all these steps fostered exports of goods and services (mainly tourism) which doubled from 1.48 billion USD in 1980 to three billion USD in 1990, even though the rise was not sufficient to offset the accumulative imports due to a increasing demand under expansionary fiscal policies as well as the reduction of tariff rates (WTO, 1995). Therefore the trade balance remained negatively associated throughout the 1980s with just three exceptions in 1982, 1984, and 1986 where a slight surplus had been achieved (Chart 5b).

2.3. Trade policy since the accession to GATT

Costa Rica joined GATT on November 24th 1990 as the 100th contracting party and agreed with its accession to reduce tariffs, to eliminate import surtaxes and surcharges, as well as import licensing and quantitative restrictions (WTO, 1995). Chart 6 shows the slumping of the average tariff rate from 1992 on. Import surcharges which covered 43 percent of tariff lines in 1987 were eliminated in March 2002. Beginning with the abolishment of CAT due to budget deficits in 1990 Costa Rica now pursues a more neutral regime with reducing import barriers as well as export incentives.

In a study, Stanley and Bunnag (2001) found that Costa Rica in fact diversified its export scheme until 1995. Relatively little is compared to other

Latin American countries, but the earning trend of non-traditional goods has been inversely associated to those of traditional goods. Timely booms in textiles and electronic parts have offset some of the losses occurred due to poor coffee revenues.

Although still high import taxes are levied on some goods like new cars and agricultural products such as milk, poultry, beans, rice and sugar, Costa Rica has become one of the most opened economies in Latin America.

3. Similarities and differences

Comparing the foreign trade policy of Mexico and Costa Rica, a great deal of similarities can be found in the basic pattern, whereas some differences occurred in the details. Both nations implemented an ISI strategy since the 1950s and faced the same problems like budget and trade balance deficits and escalating foreign indebtedness leading to a debt moratorium virtually at the same time. It has been international institutions such the IMF and the World bank which gained significant influence and pushed changes in the economic policy towards market liberalisation, privatisation, and reduction or elimination of import barriers. Both countries finally joined GATT and concluded several multi- and bilateral trade agreements last but not least with each other.

During the era of trade liberalisation in the 1980s and early 1990s, some differences can be observed. Whilst Mexico confined itself to abolishing import barriers, Costa Rica actively encouraged exporting through the installation of free trade zones and subsidizing exporting companies at least in the non-traditional sector. Another difference is the extent to which the tariffs have been lowered. Both countries had an average tariff rate of approximately 22 percent in 1985. Whereas Costa Rica reduced its tariff rates to less than 5 percent in 2004, Mexico stopped the cutting in 1988 and begun to raise the protection slightly.

Taking the ratio “trade as percentage of GDP” as a measure for openness, it can be seen in Chart 7 that Costa Rica has always been more open than Mexico. This is due to the fact that Costa Rica does not have the same endowment of raw materials (especially crude oil and natural gas) and that its

domestic market is only a fraction of Mexico's. Costa Rica has always been more open than the rest of Latin America, whilst Mexico exceeded the average in the midst of the 1980s due to its strong liberalisation efforts.
Even if the basic pattern is quite similar, there are some differences. Even during the period of the ISI policy, the ratio of trade and GDP increased in Costa Rica, whereas it stagnated or declined slightly in Mexico at least until 1975. Striking are the two outliers in 1974 and 1981, where the ratio in Costa Rica increased. This can be partly explained by the strong increase of imports in these years and at least in 1981 with a negative economic growth. The sharp rise in 1995 in Mexico is due to the NAFTA agreement promoting trade with the USA.

IV. Growth

1. Mexico

Chart 8 in the appendix shows the annual growth rates of the Mexican GDP from 1961 to 2003. It is noticeable that the growth rates have been positive throughout the four decades with only five exceptions. The exceptionally high growth, on average 6.9 percent p.a., between 1961 and 1981 demonstrates that it has not been the dissatisfying economic performance that brought the ISI strategy to an end but the increasing foreign trade deficit, the immoderate government deficit, and the excessive foreign indebtedness. It has to be mentioned that a big share of the growth rates have been realized by high-prized petroleum exports. Due to the devastating crisis in 1982 the growth rates decreased in 1983 and 1984. The average growth rate sank to 1.86 percent p.a. in the 14 years until 1994. It can be seen that the efforts for macroeconomic stabilisation showed effects from 1987 on when growth rate substantially returned to the positive zone.
The severe crisis in 1994 stunted the growth rate minus 6.17 percent, the highest recession in the last four decades. Mexico's economy recovered considerably fast and came back to considerably positive growth rates already in the following year. Since the small decline in 2001, Mexico showed moderate growth rates of 0.73 and 1.3 percent in 2002 and 2003 respectively.

2. Costa Rica

Chart 9 in the Appendix illustrates the growth rates of the Costa Rican GDP from 1961 on. At first glance a strong dichotomy can be seen. In the period from 1962 to 1980 the economic growth was rather strong with rates up to nearly 10 percent and an average of 6.24 percent. This era of economic prosperity was followed by two years of recession with negative growth of 2.26 percent and 7.29 percent in 1981 and 1982 respectively. The years from 1983 until today are characterised by positive growth rates which, however, are subject to fluctuations and reach an average level of 4.64 percent p.a.

A study conducted by Thornton and Molyneux (1995) dealt inter alia with the interrelation of economic growth and tariff policy in Costa Rica and the question of the direction of causality. They found that there was on the one hand a significant and negative causal relationship from real GDP to tariffs, "suggesting that economic growth has facilitated trade liberalization" (Thornton et al., p.641). On the other hand there was no evidence that tariffs cause real GDP or that they hamper GDP growth.

3. Similarities and differences

Chart 10 in the appendix shows the development of the GDP of Mexico and Costa Rica. In order to reach comparability the figures are stated in constant USD in the year 2000 and have been indexed to the value of 100 in 1960. Until the years of crisis in the early 1980s the growth was pretty identical. Throughout the 1980s Mexico seemed to have recovered faster from the devastating crisis 1982 and achieved higher growth rates than Costa Rica. But in 1994 the accumulated growth in Costa Rica exceeded Mexico's and has stayed there until today.

In the four decades since 1961 the GDP on a constant 2000 USD basis has reached the septuple of its initial value in Costa Rica, whereas Mexico's GDP still grew by 627 percent. Both countries thus surpassed the average of all Latin American countries especially in their growth since the years of crisis.

V. Conclusion

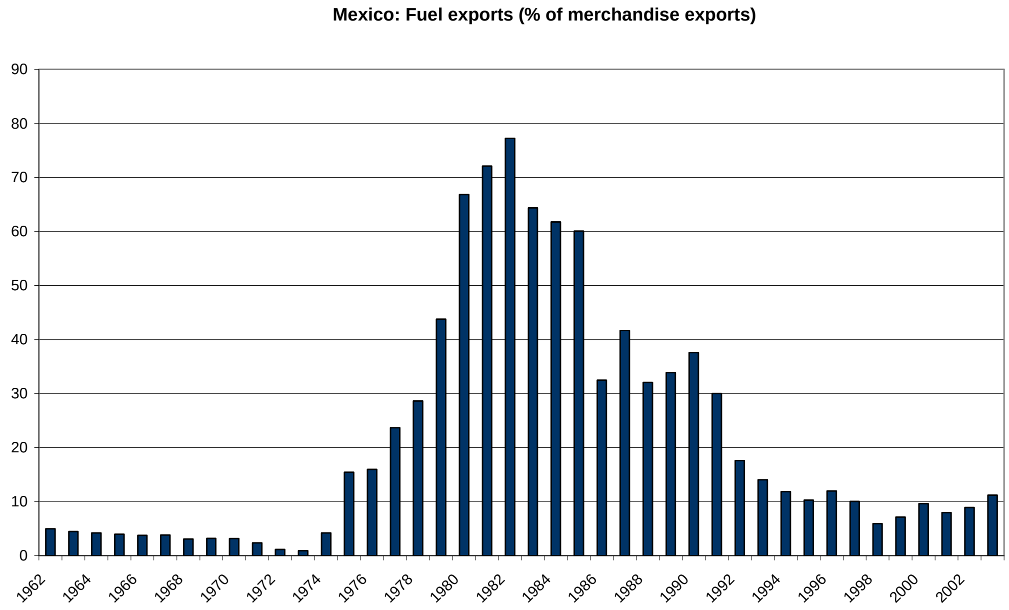
The table on the right summarizes the results. It shows considerably higher growth rates during phases of higher economic protection in both nations and seems thereby to disprove the thesis that the elimination of trade barriers fosters economic growth. However, by adopting a more critical view, several limitations have to be taken into account. First, the average growth rates after the crisis encompass years of implementing a comprehensive austerity program which has negative effects on growth at least at the beginning. Second, it is questionable whether the ratio of the sum of the values of imports and exports adequately reflects the foreign trade policy. And third, most importantly, even though both countries achieved very high growth rates during the pursuit of a strategy of import-substituting industrialisation, this policy was not sustainable at all, hampering technological progress, causing an extensive trade balance deficit, and leading to an unmanageable external indebtedness. It was this kind of policy that led to the devastating crisis in 1981 and 1982 respectively.

		Before Crisis	**Since Crisis**
Costa Rica	Growth	5.88	3.82
	Openness	61.48	80.04
Mexico	Growth	6.83	0.71
	Openness	18.63	44.18

Before Crisis: Costa Rica: 1961-1980
Mexico: 1961-1981
Growth: average annual growth rate of GDP
Openness: average ratio of trade and GDP

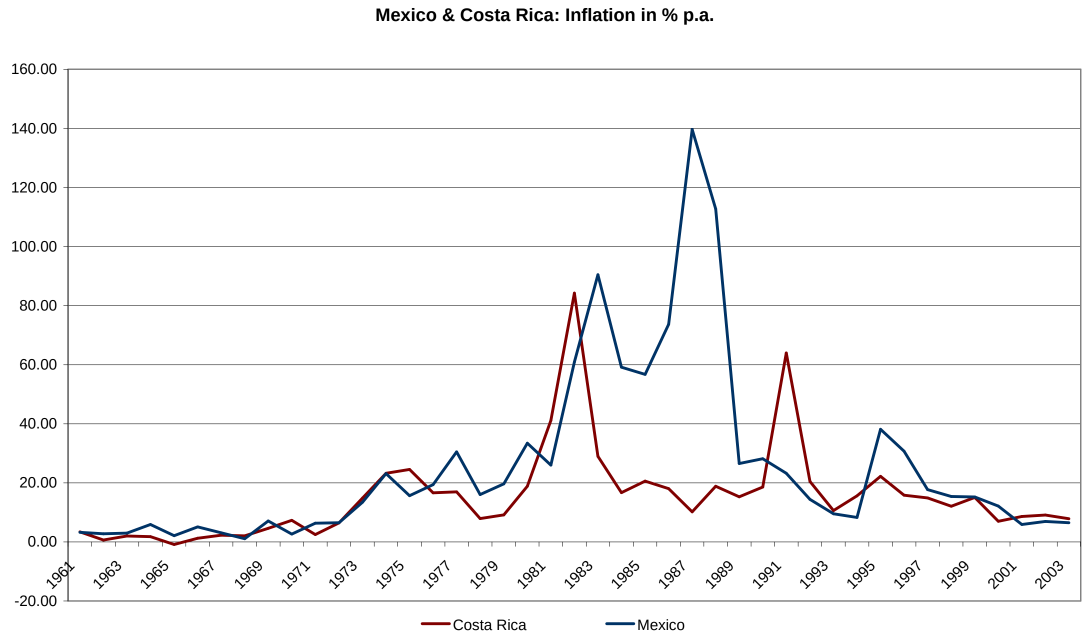
Appendix

Chart 1



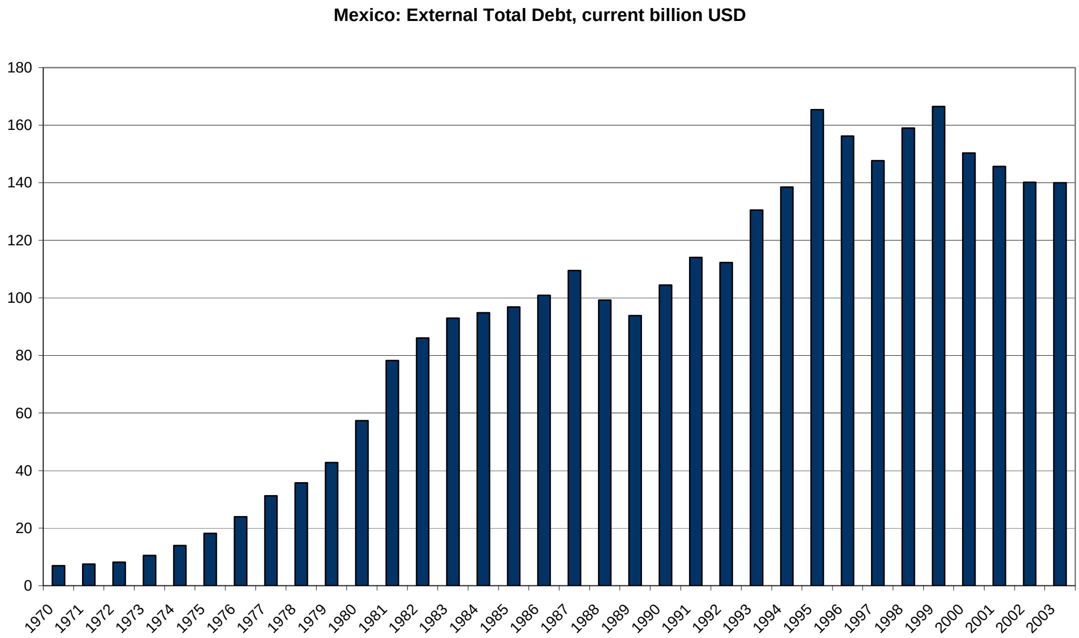
Source: World Development Indicators, World Bank 2005

Chart 2



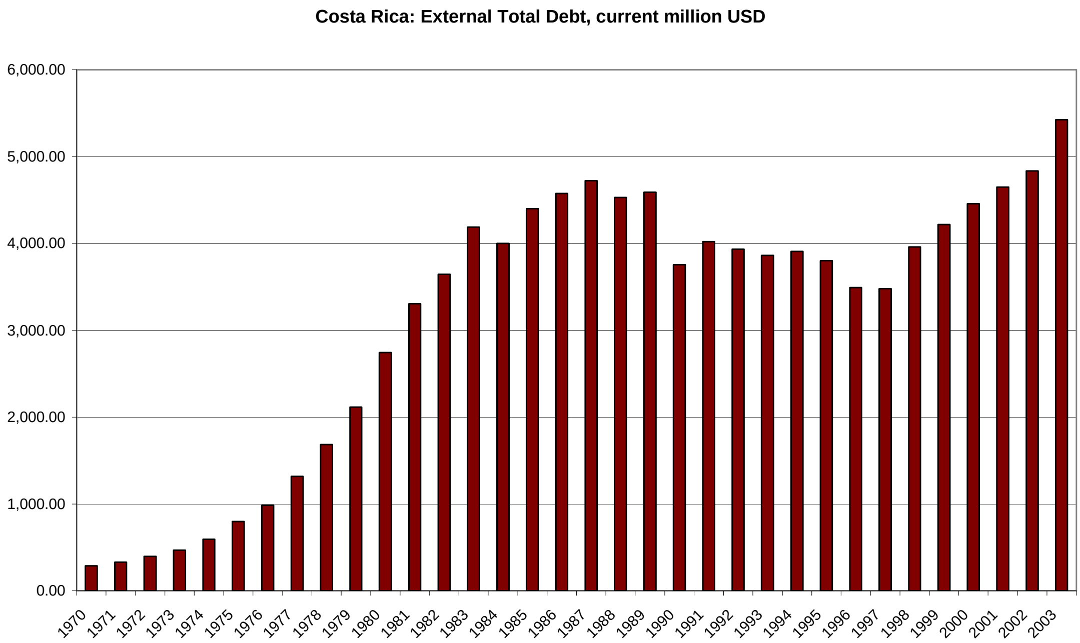
Source: World Development Indicators, World Bank 2005

Chart 3a



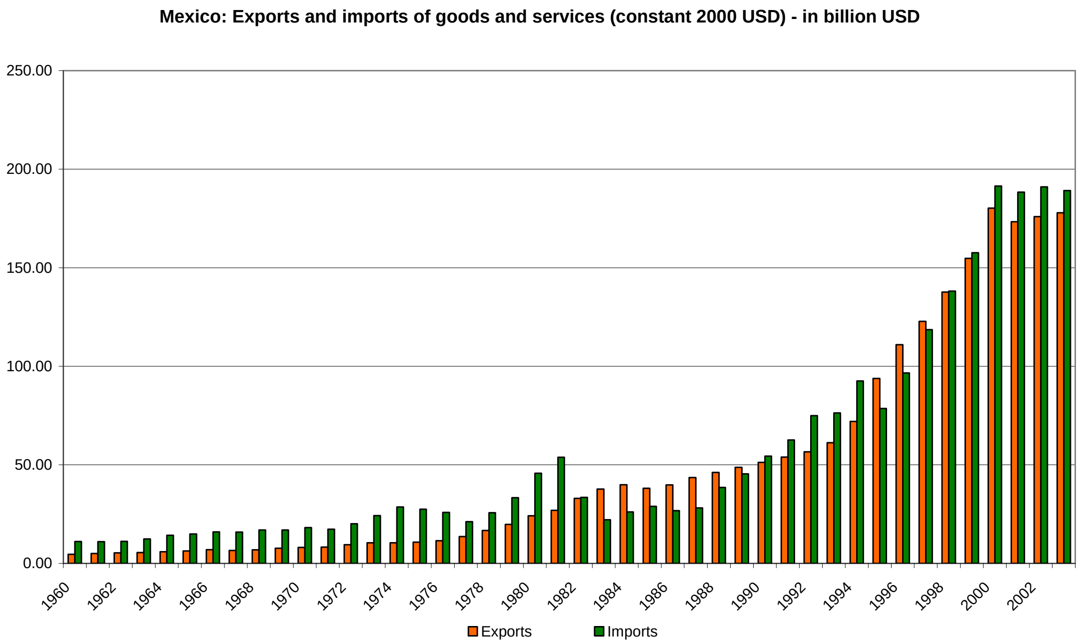
Source: World Development Indicators, World Bank 2005

Chart 3b



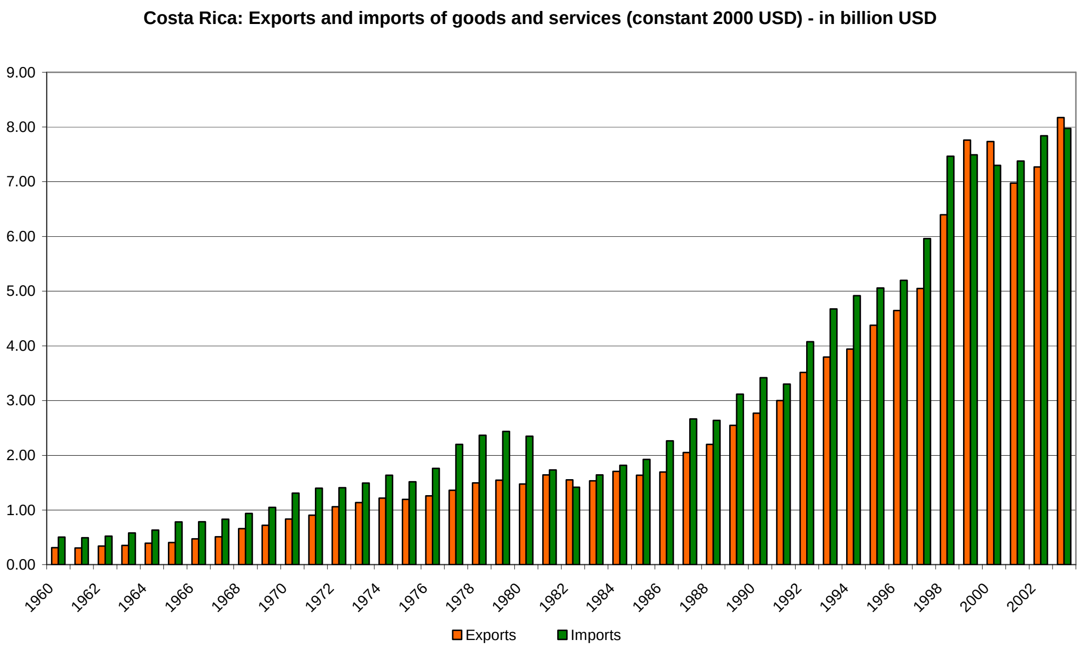
Source: World Development Indicators, World Bank 2005

Chart 4a



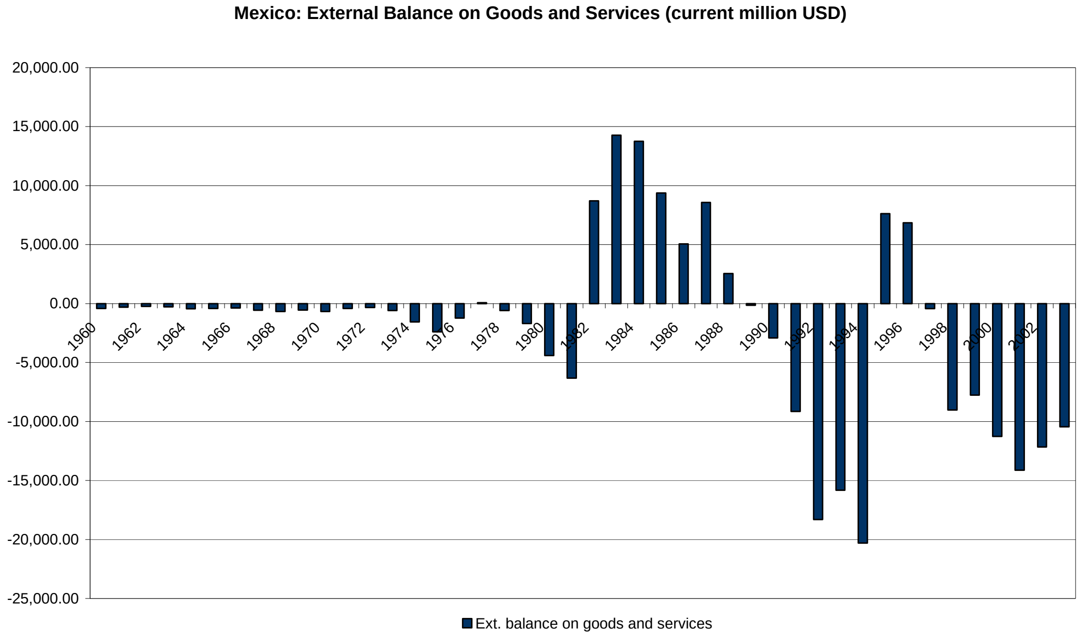
Source: World Development Indicators, World Bank 2005

Chart 4b



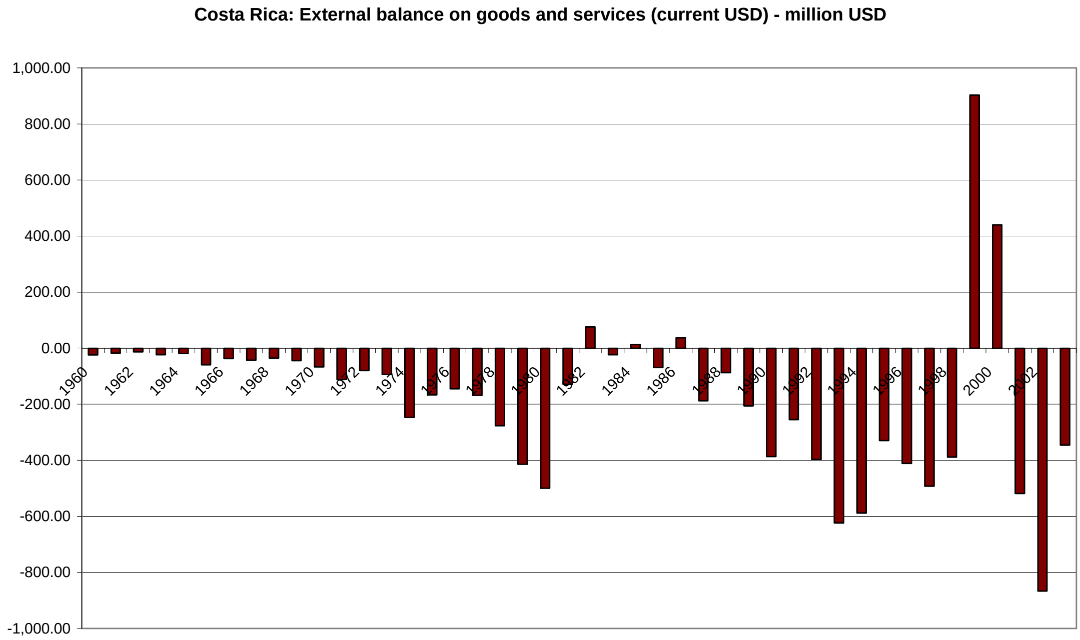
Source: World Development Indicators, World Bank 2005

Chart 5a



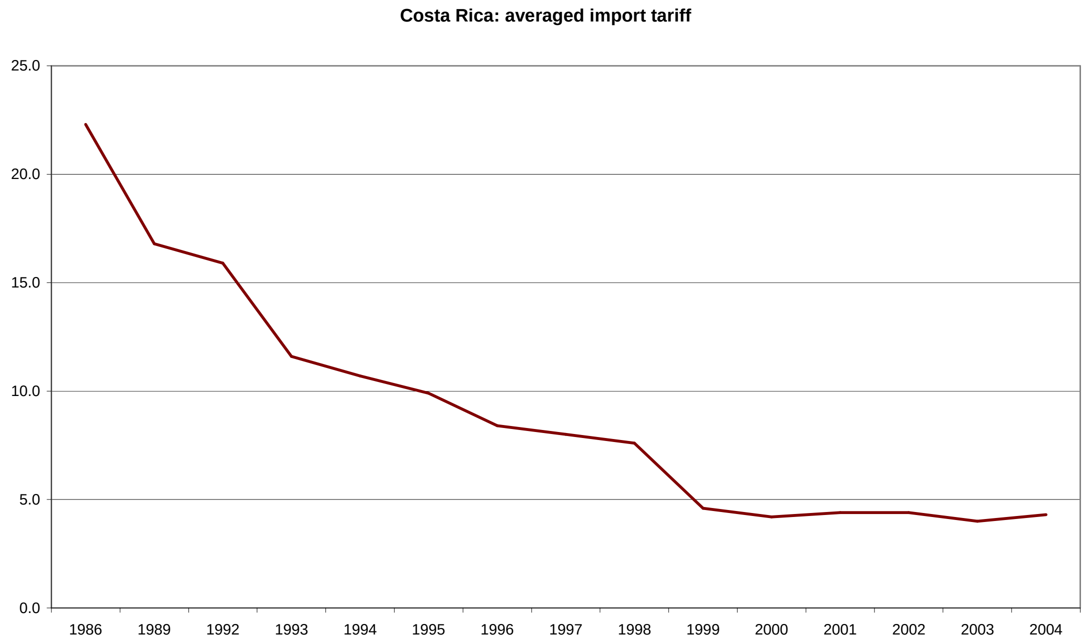
Source: World Development Indicators, World Bank 2005

Chart 5b



Source: World Development Indicators, World Bank 2005

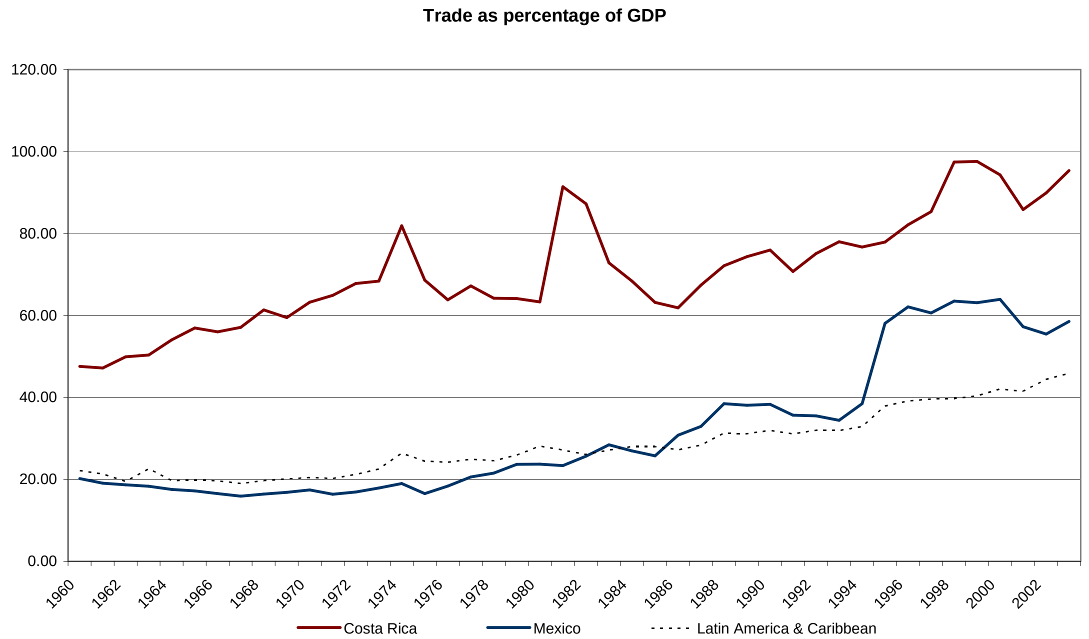
Chart 6



Source:
Until 1994: Ministry of Finance; Ministry of Foreign Trade (data for 1994); adopted from WTO (1995); since 1995: COMEX (2004)

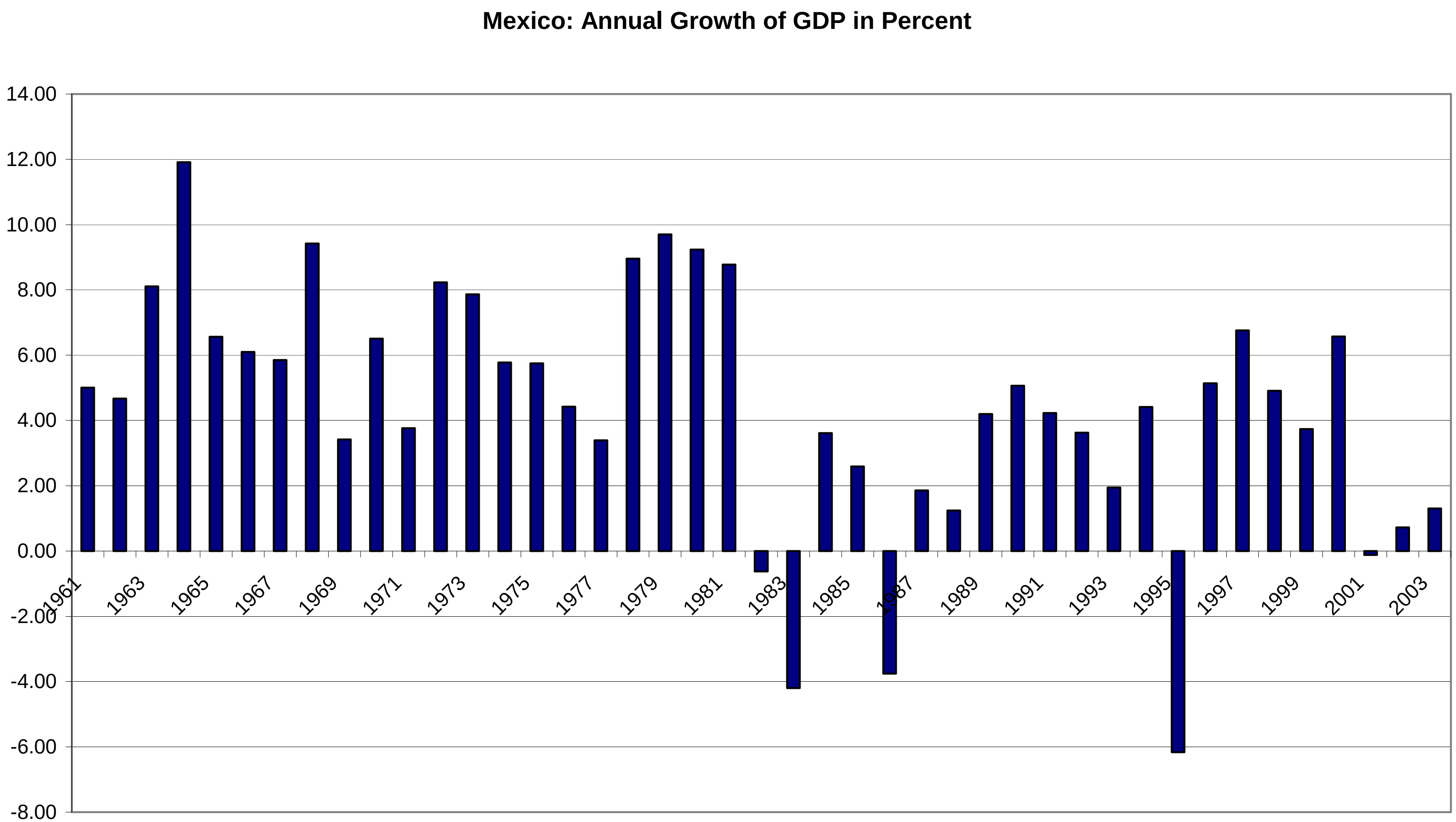
Note: 1. Average tariff rates supplied by the Ministry of Foreign Trade for the years 1986, 1989, and 1992 differ considerably from these rates; these are 42.74 per cent, 20.97 per cent and 13.29 per cent, respectively
2. Average tariff rates are weighted by economic sectors from 1995 on

Chart 7



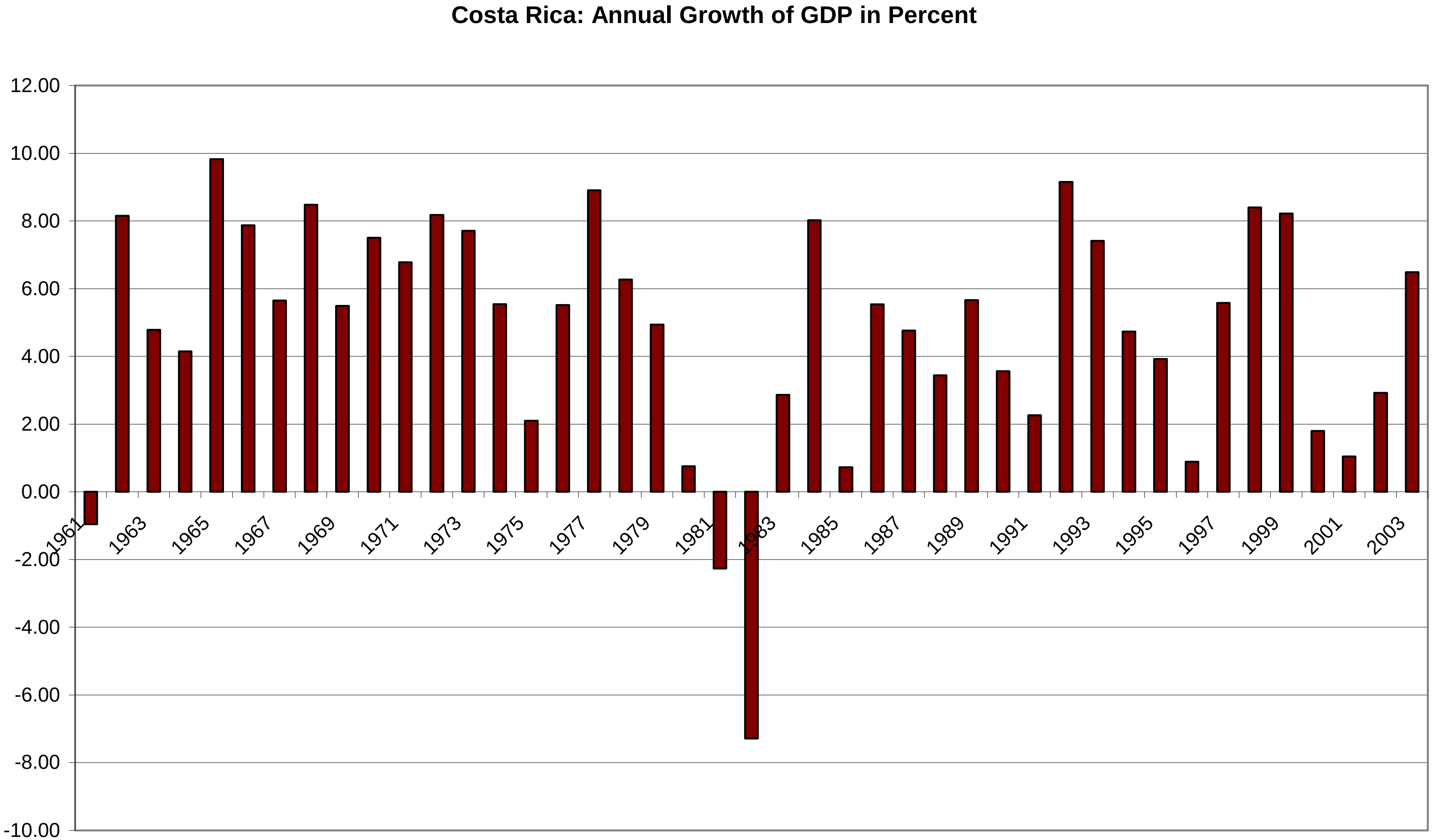
Source: World Development Indicators, World Bank 2005

Chart 8



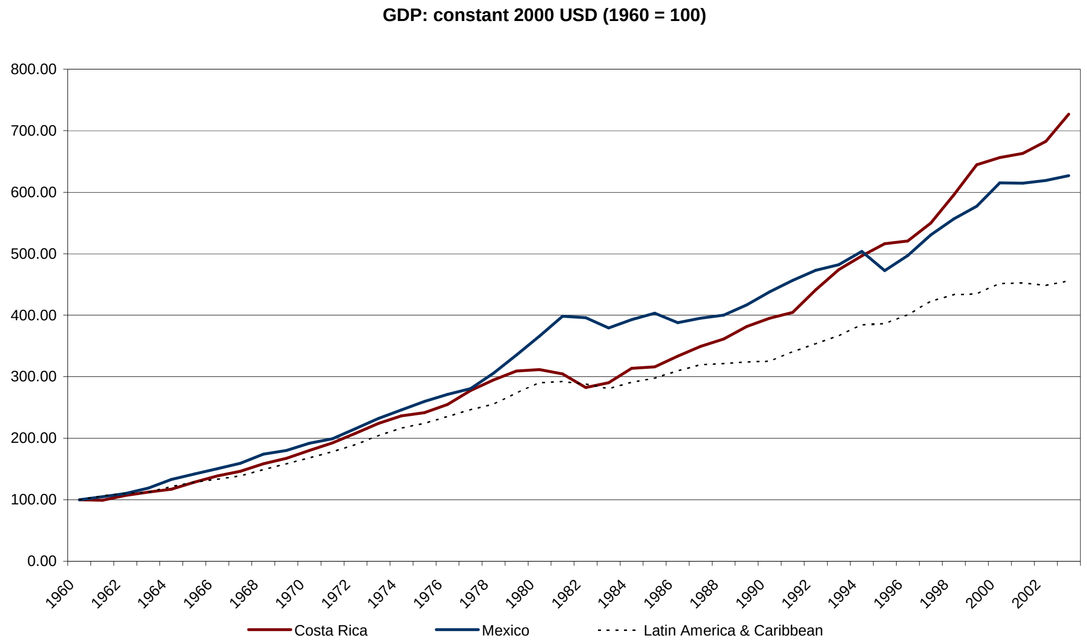
Source: World Development Indicators, World Bank 2005

Chart 9



Source: World Development Indicators, World Bank 2005

Chart 10



Source: World Development Indicators, World Bank 2005

Table 1

Liberalisation of trade restrictions (per cent)

	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994
Import license coverage	100	83	35.1	27.8	26.8	21.2	14	13.7	9.1	10.7	21.5	12.97
Reference prices	13.4	13.4	25.4	18.6	13.4	0	0	0	0	0	0	0
Tariffs:												
Simple average	27.0	23.3	25.4	22.6	10.0	9.7	13.1	13.1	13.1	13.1	13.0	12.4
Trade weighted averaged	16.4	8.5	13.3	13.1	5.6	6.2	10.1	10.5	11.2	11.5	11.6	11.0
Tariff positions	16	10	10	11	5	5	5	5	5	6	6	8
Maximum tariff	100	100	100	100	20	20	20	20	20	25	25	25

Source: OECD (1996) p.114

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