

TRADE POLICY AND POVERTY IN PERU

How do free trade agreements (FTA) impact rural poverty?

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1. To understand the relation between international trade and poverty in Peru, it is fundamental to explore how trade impacts on agricultural activities since most of the poor depend on them to sustain their livelihoods.

2. Evidence from Peru shows that the FTA with the US could produce a financial gain of US\$ 575 millions in urban Peru, but losses of US\$ 158 in rural Peru. This situation highlights the need for pro-poor complementary policies that can secure the livelihoods of the poor.

3. An increase in rural poverty will have collateral effects as the deterioration of family expenditure in education, while also a massive school drop out that will push children and adolescents to engage in economic activities. Access to health services may also be affected.

4. The establishment of specific product subsidies is not convenient to tackle the potential negative impacts of the FTA in Peru. A better policy option would be that conditional-cash transfers programs –as Juntos- focus their actions in generating economic opportunities for the poor affected by the FTA.

Introduction

The link between trade liberalisation and economic growth does not appear to be conclusive. For some authors, liberalisation favours economic growth, while others indicate that it is an export-led strategy, rather than the elimination of trade barriers for imports, that promotes economic growth.

In Peru, given that the great majority of the poor depend directly or indirectly on agricultural and farming activities in order to sustain themselves, in order to evaluate the impact of international trade on poverty we need to examine how trade influences these activities. What is the effect of trade liberalisation on the agricultural and farming sectors in Peru? The answer to this question is complex, because in our countries tradable agricultural and farming goods, that is, products for export or for the substitution of imports, coexist with non-tradable goods, or products that are exclusively for the domestic market and do not compete directly with imports.

Meanwhile, globally, the unilateral international trade liberalisation in the 1980s and the beginning of the 1990s has been replaced by free trade agreements between two or more countries. In the case of our country, a free trade agreement (FTA) has been signed with our principal trading partner, the United States of America.

Do traditional trade policies, which constitute unilateral liberalisation to facilitate imports from the rest of the world, and new trade policies, based on bilateral agreements, contribute to the development of the agricultural and farming sector, and, thus, to poverty reduction?

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«The experiences of East Asia and, recently, China have framed the discussion: is it the insertion in international markets through exports, rather than opening up to imports, that favours economic growth? »

The objective of this article is to answer this question. In the following section, I will present a recent analysis that connects trade policy and poverty, at the international level. In section 2, the same issue is discussed, but in the Peruvian case. In section 3, I will review Peru's FTA with the United States and its implications for poverty. Finally, section 4 will present some conclusions and implications for economic policy.

1. Trade policy and poverty: international evidence

The link between trade liberalisation and economic growth is far from clear². According to one school of thought³, trade liberalisation favours economic growth. According to these authors, the countries that are the most open to international trade grow more than those that are less open (open countries converge more rapidly to the level of developed countries). In this way, the poverty reduction observed in recent decades, economic growth, and the increasing globalisation of trade would be considered to be aspects of the same phenomenon.

However, there are other economists who are less convinced of the benefits of international trade. Authors such as Rodrik (1995) and Stiglitz (2006), among others, caution that the relationship found between trade liberalisation and growth could be spurious, due to the difficulty of establishing an

exogenous indicator of trade liberalisation. Moreover, these authors claim that it is export-led strategies, not the elimination of trade barriers, that act as the motor for growth. The notable growth of the Chinese economy over the past few decades contributes to the strength of this analysis⁴.

The experiences of East Asia and, recently, China have framed the discussion: is it the insertion in international markets through exports, rather than opening up to imports, that favours economic growth? The economic growth in China of the past 20 years has certainly contributed to an important degree to 400 million people rising out of poverty.

Trade policy, thus, under certain conditions, can contribute to economic growth. And what does the international experience tell us about the links between economic growth and poverty reduction?

According to Mendoza and García (2006), at the international level, the positive relationship between macroeconomic performance, as measured by GDP, and poverty, as the percentage of the population whose levels of consumption or income do not reach the cost of the basic basket of goods to satisfy their needs, is evident. According to Dollar and Kraay (2001), economic growth is fundamental for permanent poverty reduction. The Chinese experience of notable poverty reduction, as depicted by Sachs (2006), is another convincing example of the importance of economic growth. Finally, according to Sala-i-Martin (2007), over the past three decades, global economic growth has accelerated and poverty rates have been reduced to about two-thirds of prior levels.

2. Trade policy and poverty: The Peruvian Case

Trade policy in Peru has been determined by essentially macroeconomic needs, that is, to open the economy to international trade, correct external disequilibria or increase protections for local industry, and not for its probable effect, in one way or another, on poverty and inequality.⁵

The government of Velasco Alvarado (1968-1975) deepened the import substitution model inherited by his administration, by imposing considerable tariffs and a bundle of non-tariff measures, including the prohibition of a large group of imports and the requirement of licenses to import certain goods.

2/ For a balanced treatment of this issue, see McCulloch, Winters and Cirera (2002).

3/ Sachs and Warner (1995), Edwards (1997), Frankel, Romer and Cyrus (1996), Berg and Krueger (2003) and Sala-i-Martin (2007).

4/ Sachs and Thye (1997).

5/ See for example Rojas (1996, 1997) and Morón et al (2005) for a description of the trade policy of recent decades.

Towards the end of the 1970s, the turn towards greater trade liberalisation began, with the elimination of the National Registry of Manufacturing, the dismantling of exchange controls and the reduction of the average tariff rate to approximately 40% in 1979, which was interrupted by the debt crisis and international recession. These events forced the government to increase the average tariff rate, and, with the election of García in 1985, revive prohibitions, licensing regimes and differentiated exchange rates.

This development model that emphasised the domestic market was eliminated in the beginning of the 1990s, during the Fujimori administration, through one of the most radical liberal reform movements of Latin America. Between 1990 and 1991, the dominant trade structure was demolished, tariff rates were drastically reduced, quantitative controls on imports were eliminated, and almost all non-tariff restrictions as well as the differentiated exchange rate system were repealed⁶.

Given that the vast majority of the poor in Peru directly or indirectly depend on agricultural and farming activities for their survival, it is appropriate to focus attention on this sector in order to assess the effects of international trade on poverty.

What is the effect of trade liberalisation, understood as a unilateral tariff reduction, on the agricultural and farming sector in Peru? The answer to this question is complex⁷, because, in Peru, there are many agricultural and farming sectors.

In aggregate terms, one can distinguish between two types of agricultural and farming activities. The tradable agricultural and farming activities, whether exportable or importable, where prices are determined by international prices, the exchange rate, and by

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tariffs and subsidies, and an excess of supply or demand are faced with more imports or exports, and non-tradable agricultural and farming activities, that are produced exclusively for the domestic market and that do not face foreign competition, where supply is given in the short term and prices are flexible and adjusted based on the excess of supply or demand.

In this framework of general equilibrium, tariff reduction for imported goods does not only affect price parity of imports and exports, but also distinct functions of supply and demand of non-tradable agricultural goods.

A reduction in tariffs can cause a decrease, in the first place, in the price of importable agricultural and farming goods, which would benefit consumers, by lowering prices for those that have access to markets; but it would harm the producers of importable goods, by reducing income from sales of these producers. Given that agricultural and farming tradable goods are substituted by non-tradable agricultural and farming goods (Hopkins, 1994), the price reduction of importable goods causes a drop in the demand for non-tradable agricultural and farming goods, depressing their prices and affecting the income of producers of non-tradable agricultural goods.

In this way, trade liberalisation can harm not only producers of agricultural and farming goods for import, but also producers of non-tradable goods.

Thus, the beneficiaries of import liberalisation would be agricultural and farming exporters, because liberalisation can cause a drop in the price of their imported inputs for the productive process.

^{6/} See Rossini (1991).

^{7/} According to Mendoza (1992, 1994).

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3. The Free Trade Agreement with the United States and poverty

Over the past few years, the unilateral liberalisation for international trade of the 1980s and the beginning of the 1990s has been replaced by free trade agreements between two or more countries. According to Sala-i-Martin (2007), currently, 40% of world trade is supported by free trade agreements; there are approximately 200 free trade agreements in operation and another 60 under negotiations.

Peru has signed a free trade agreement (FTA) with its principal trade partner, the United States. The FTA constitutes the deepening of a process of trade liberalisation which has been underway in Peru since 1990. Subsequently, the Andean Trade Preferential Act (ATPA) was signed in 1991 and the Program for Andean Trade and the Andean Trade Programme and Drug Eradication Act (ATPDEA) was signed in 2002.

With this treaty⁸, our country, rather than promoting a permanent extension of the ATPDEA and a gradual reduction, over a period of up to 17 years, of the majority of tariffs for those Peruvian agricultural and farming products considered sensitive, has offered concessions by diminishing import tariffs for American products. The treaty also accepts that the United States will maintain unaltered non-tariff restrictions for Peruvian products and authorises the protection of test data for pharmaceutical and chemical products.

8/ Regarding this issue, see Fairlie (2006) and Tello (2006).

9/ Zegarra (2005)

What is the probable effect of this group of agreements on the agricultural and farming sector and on poverty?

Some analysts sustain that the FTA will provoke a greater drop in prices of the basic products of the food basket, massively subsidised by the U.S., such as grains, milk, oil products, sugar and fibres and, as a result, will depress the prices of goods produced in traditional agriculture⁹. Furthermore, since the FTA requires the dismantling of the free price zone system, the prices of products such as rice, sugar, milk, and, to a lesser degree, yellow corn, will be reduced, aggravating the situation for agricultural producers of these import goods.

Because the non-tradable agricultural and farming goods are, in general, substitutions for tradable goods, the prices of these non-tradable products, widely produced in the South Sierra, such as potatoes, barley, and white amilaceo maize will also be reduced.

In this way, the terms of trade for importable and non-tradable agricultural goods would deteriorate. The new agreement will likely benefit agricultural exporters, due to the opening of the American market for their products and the decrease in tariffs of some imported inputs.

In a similar vein, Escobal and Ponce (2006) affirm that the effects of the FTA in the short term could be fairly heterogeneous among geographic areas and population groups with different characteristics. A simulation exercise indicated that the FTA would produce profits of around US\$ 575 million in urban Peru, but losses of US\$ 158 million in rural Peru.

The increase in rural poverty would have several collateral effects. As the income of rural households drop, school attendance could be negatively impacted by the combined effect of a reduction in education spending and increased truancy, due to the need for children to generate income to help support the family. The other effect of the reduction of income in rural areas is the impact that it will have on health in rural populations, by affecting the capacity of the poor to access health services.

4. Conclusions and implications for economic policy

What are the effects of trade policy on economic growth? International trade favours economic growth

when the emphasis is placed on exports, before the unilateral reduction of tariffs.

And what is the relationship between economic growth and poverty? In the literature reviewed here, the relationship between economic growth and poverty is indeed solid; all economies that have managed to significantly reduce poverty have also exhibited sustained growth, through international trade or by other means.

And what is the link between trade policy and poverty? Given that the great majority of the poor in Peru depends directly or indirectly on agricultural and farming activities for their survival, in order to understand the link between trade policy and poverty in Peru, we must first analyse the relationship between trade policy and the agricultural and farming sector. When trade policy constitutes an opening for imports, rural poverty can be aggravated.

What would be the effects of the FTA with the U.S. on poverty? The official government claim is that the FTA is essentially an opening of the North American market for Peruvian products. However, the FTA is not only an opening of the North American market for Peruvian products. The opening of the North American market was achieved with the ATPDEA. The number of additional items that were not present under the ATPDEA and that were consolidated under the FTA is rather limited. As a result, apart

from the fact that the FTA solidified the opening of the North American market, which was transitory with the ATPDEA, the FTA is, essentially, an opening for American imports, with negative consequences for the producers of non-tradable agricultural and farming goods.

As a result, there should be special attention paid to the study of compensatory policies for those who are conceptualised as the “losers” of the FTA. The study of the Mexican and Chilean experiences could be very useful in this regard. As Grade cautions (2006) in a critique of the Mexican program to compensate producers of wheat, corn and cotton who could be affected by the FTA with the U.S., the fact that compensation was directed towards specific products, and not towards all the producers, generated an unforeseen and undesirable consequence, because it provided incentives to produce less profitable agricultural goods, despite having expanded markets for much more profitable goods.

Under these conditions, the recommended solution is for programs of conditional monetary transfers, in order to create a social support network for vulnerable populations in the rural sector. Social protection programs such as JUNTOS could be expanded and should concentrate on promoting opportunities and economic capabilities for those affected by the FTA. ◆

This document has been produced as part of “Trade and Poverty in Latin America” (COPLA), project implemented in Peru by the Economic and Social Research Consortium (CIES). COPLA is financed by the Department for International Development (DFID) through the Overseas Development Institute (ODI) and is also implemented in Bolivia and Nicaragua. COPLA aims at strengthening evidence-informed policy dialogue on trade, poverty and social exclusion in Latin America. For further information please visit: www.cop-la.net

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