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The United States-Peru Trade Promotion Agreement: What Did You Expect?

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Abstract: Bilateral free trade agreements have generally been analyzed as instances of preferential reciprocal tariff liberalization. Viewed through this lens, such agreements raise concerns both about new competition and about trade diversion. The United States-Peru Trade Promotion Agreement, an example of a serious North-South accord, demonstrates that new market access was not a principal Peruvian goal in the trade negotiations. Instead, the agreement was intended to encourage investment by locking in Peru's economic reforms. This motivation has very different implications for the global trading system than a quest for preferential access.

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1) Introduction

Bilateral free trade agreements have been the major means of opening markets over the last decade, but they have been attacked on two fronts. Critics of trade liberalization dislike them for obvious reasons. However, some advocates of trade liberalization also dislike them because they are seen as distracting from the goal of worldwide free trade. This latter group tends to misinterpret what free trade agreements do and the broader benefits they can bring.

This study aims to explore those broader benefits through an in-depth look at the case of Peru. In particular, it seeks to shed light on some of the debates about free trade agreements by asking what the Peruvians sought to achieve through the FTA. Were they seeking new access to the United States market? Or were they using the agreement as a vehicle to strengthen economic and governance reforms?

Although these explanations have been offered for FTA participants around the world, there are some reasons why Peru offers a particularly interesting application. Not only did Peru suffer through past periods of economic mismanagement and poor governance, but the current President, Alan Garcia, previously presided over one of the worst episodes. The FTA with the United States offered one of the only ways that the Peruvian government could commit itself credibly to pursuing a broad range of better policies. Further, if we are interested in what countries hoped to achieve in pursuing an FTA, Peru offers the freshest set of expectations available, still untainted by much subsequent experience with the operation of the agreement.

A major focus of this study is the extent and means by which FTAs function as a means of committing to better governance. Some of this is embodied in the agreement itself, with chapters covering investment and dispute resolution. Some of it comes from the signal it sends about the government's beliefs and priorities.

One of the failings of the academic literature has been a tendency to approach FTAs as a mere reciprocal lowering of tariffs. There is a practical reason for this approach: it is very difficult to model systematically the other things that an FTA does. While there are alternative approaches in the literature reviewed below, they tend to be broad and empirical, without firm theoretical foundations. A case study offers an opportunity

to address familiar liberalization questions, but also to delve into some of the subtler questions that have yet to be well-addressed in the literature.
The study suggests that Peruvians were far more interested in locking in economic reforms and attracting investment than in gaining new market access or moving the terms-of-trade in their favor. They saw the FTA as an integral part of broader economic reform and as a springboard to liberalization with the rest of the world.

In some ways, the Peruvian case is ideal for disentangling the different effects of FTAs which are expounded in the academic literature. Most notably, Peru already had virtually tariff-free access to the U.S. market through the U.S. preference measures.

It is not a perfect natural experiment, however. Peru benefited greatly from a worldwide commodities boom that was contemporaneous with pursuing and signing the FTA with the United States. That is an important part of the backdrop to the story about learning and the dynamics of trade liberalization that is taken up later in the paper.

Peru sheds light on the central schisms in the trading world today. The World Trade Organization reached an impasse in 2008, in part over the proper rights and obligations of advanced developing countries. Those obligations have historically been low in the WTO and high in FTAs. The different branches of the U.S. government reached an impasse over the desirability and impact of FTAs – Peru was the last to pass before this rift brought action to a halt.

The next section reviews some of the major hypotheses in the literature about why countries pursue FTAs and what those agreements do. Section 3 offers some background on Peru's economic history and the role that trade has played. It also describes the key features of the U.S.-Peru Trade Promotion Agreement (PTPA). Section 4 reports the findings of a series of interviews with Peruvian former officials, academics, and businessmen. It uses those interviews to consider the hypotheses of Section 2 as well as to explore some novel arguments about the political economy of trade agreements. Section 5 concludes.

2) Hypotheses to explore

A) The question of motives

There is a substantial literature theorizing about free trade agreements and a smaller one offering empirical tests of those theories. For the most part, the question of participating countries' motives is not very salient in the literature. The motives are usually just implicit in the theoretical framework that is used to analyze the problem.
In a classic trade model, for example, we might have two countries with some endowments of goods or factors of production. The countries have some preferences over the goods they ultimately consume – a social welfare function – and they manipulate a tariff on imported goods so as to maximize their well-being. Many models offer slight variations on this theme. We might introduce a third country, which allows two countries to discriminate against the third with their tariffs. In a political economy version, we might have interest groups or heterogeneous individuals within our countries, which can reshape the social welfare function to give additional weight to the interests of those who are somehow favored.

Ultimately, though, free trade agreements are analyzed as exercises in which tariffs are removed between the signatory countries and we assess how those countries' welfare changes. FTAs have been a subject of economic analysis since at least the early days of the current global trading system, just after World War II. At that time, the General Agreement on Tariffs and Trade (GATT) allowed an exception to its core principle of non-discrimination among trading partners. Article XXIV permitted FTAs so long as they covered substantially all trade between the participating countries and were completed in a timely fashion.

One motivation for this exception was to meet the potential need for politically-motivated economic integration, as when the recently fractious nations of Western Europe decided to cooperate economically. It was not uncommon for FTAs to be driven by non-economic motives, like ensuring a lasting peace in Europe or cementing a political alliance (the first U.S. FTA was with Israel). These motives were sufficiently non-economic, however, that they lay outside the plausible realm of economic modeling; the politically-motivated agreements could be treated as exogenous for analytic purposes.

It poses a substantially greater challenge for our understanding of FTAs if agreements are pursued for economic motives that are poorly represented by the standard model of reciprocal tariff liberalization. It would suggest that the models are missing potentially important aspects of the relevant behavior. Extrapolations that rely upon misread motives could offer misleading predictions about where the world trading system is headed. Political debates that rely on the economic analyses may misjudge agreements under consideration. Efforts to assess the impact of FTAs may focus on the wrong aspects of subsequent experience.

These are not purely hypothetical possibilities. In fact, there has been a remarkable proliferation of FTAs in recent decades. These FTAs have ranged from high-standards agreements which imposed detailed restrictions reaching far beyond tariff elimination to agreements that serve as little more than statements of political amity with an inclination toward future liberalization. This heterogeneity imposes a challenge for theoretical and empirical researchers. For theoretical researchers, the tool set for dealing with reciprocal tariff reduction is much better developed than the modeling options for dealing with other facets of the agreement. For empirical researchers, they must choose between pretending that trade agreements are homogeneous or acknowledging the heterogeneity. The former is useful for generating large sample sizes, but is implausible with even a cursory examination of the terms of the agreements.

Acknowledging heterogeneity can leave empirical researchers with very few observations of any particular type of agreement.

This paper draws on the Peruvian experience in an attempt to shed light on the motives behind FTAs. This section offers a very brief description of some of the most prominent motives that are either explicit or implicit in the literature.

B) Reciprocal tariffs and terms of trade

The classic trade model approach sketched above has been developed and explored thoroughly in the work of Bagwell and Staiger (2002). They describe a general framework in which two or more countries contemplate trade agreements among themselves, armed with tariffs that they can raise or lower. Among the principal effects of trade agreements they list trade diversion, in which a high-cost producer exports more because of tariff preferences, and market power, in which a group of countries will use its collective power to raise tariffs and move the terms of trade in its favor (p.

117).

Bagwell and Staiger argue that this approach, in which reciprocal lowering of trade barriers is the essential feature of trade agreements, is not reliant upon a narrow apolitical view of trade liberalization. They write:

> The incentive for governments to enter into trade agreements that result in mutually lower tariffs is quite general, and in particular is in no way limited to the hypothesis that governments maximize national welfare. (p. 24).

They argue that their approach encompasses models with domestic political competition as well and conclude that the "terms-of-trade externality is the only inefficiency that a trade agreement can remedy."

This is the predominant view in the academic economic literature, but it encounters some difficulties in empirical studies. Freund (2004) considers 91 trade agreements and divides them into three commonly-used categories. This taxonomy of trade agreements is sufficiently pervasive and relevant that it is worth a brief review.

North-North agreements. These are agreements between developed nations, often members of the OECD. There are relatively few, but they are prominent (e.g., the European Union, NAFTA). The geographical description can be inapt as well, since Australia-New Zealand would be a prominent example.

North-South agreements. These are agreements between developed and developing nations. These have proliferated more recently, as the United States and the EU have paired up with partners in the developing world.
The agreement between the United States and Peru falls into this category.

South-South agreements. Of the preferential trade agreements notified to the WTO, a substantial number are between developing nations. These agreements have generally been less ambitious in the extent of liberalization and the range of issues covered than those involving developed nations. The present paper will touch briefly on this category, since Peru also participated in Andean regional efforts at trade liberalization.

Freund finds strong evidence of reciprocity in North-North and South-South agreements, but little evidence of reciprocity in North-South FTAs. At a minimum, this suggests the need for a more nuanced theoretical view of FTAs.

C) A commitment device

Ethier (1998) provides just such a view. Without offering a detailed theoretical framework nor detailed empirical results, Ethier describes a "new regionalism" that distinguishes the North-South FTAs from their more reciprocal North-North counterparts. He argues that North-South agreements tend to follow unilateral reforms and feature "deep integration" (measures that go well beyond border barriers to include items such as investment regulation). He describes the commitment to reform as a central purpose of this type of agreement and hypothesizes:

> The more likely that backsliding from an external commitment will induce retaliation, the more likely such a commitment is to sustain reform. The more that specific reform measures are embodied in an external commitment, the likelier that commitment is to sustain reform. (p. 1154)

In contrast to FTAs, he writes:

> Multilateral negotiations are...of little practical use for this purpose. They provide no enforcement mechanism should a country backslide, and large industrial countries can hardly be expected to put the multilateral system at risk merely to punish a single deviant reformer. (p. 1156)

In Ethier's view, the principal attraction of FTAs to reforming countries is the ability to attract foreign direct investment. This has negotiating implications that are radically different from the reciprocal liberalization view.

> What matters here is what the small reforming country gives, in terms of trade concessions, not what it gets, because it is the former which influences the likelihood of retaliation by the partner in the event of backsliding. (p. 1157)

More recent work by Büthe and Milner (2008) pursues this approach empirically, although they see FTAs and multilateral liberalization as having similar effects. They write that it is no longer the threat of expropriation that poses the biggest concern for foreign investors, but more subtle measures.

> Hence, policies that imply limited government intervention in the economy, such as trade and financial openness, should be attractive to foreign investors. How credible, however, is a promise to maintain such economically liberal policies?...We argue that a government can make a more credible commitment regarding present and future economic policies by entering into international agreements that commit its country to the liberal economic policies that are seen as desirable by foreign investors. (pp. 741-742)

Büthe and Milner distinguish themselves from earlier empirical work through their emphasis on political aspects of commitment. Since they include agreements that may not have explicit investment provisions, they argue that the commitment comes from the visibility of governments' public commitments, the ability of private actors to bring external pressure to bear in case of violations, and potential reputational damage for a country that violates its commitments. In their empirical estimation, they find a significant positive effect of FTA participation on inward FDI in developing countries.

D) Democracy and governance

Beyond reciprocal market access and a commitment to the equitable treatment of foreign investors, there are arguments that trade agreements can have a broader political and procedural impact. One of the Bush Administration's arguments for the FTA with Peru was that it would strengthen freedom and democracy. (State, 2007).

Aaronson (2008) discusses the role of transparency requirements in U.S. trade agreements. These requirements are aimed at providing a predictable business environment, but there can be broader positive effects emanating from more effective and open public institutions.

> U.S. policymakers also recognize that transparency can facilitate human rights...Government institutions will not function effectively without feedback. Citizens cannot provide such feedback without information about what government is doing or without the ability to participate in policymaking...Transparent, accountable governance can foster democracy, capitalism, and political stability. Thus, by promoting transparency, the rule of law, and political participation, policymakers can promote

many human rights. (p. 171).

This describes the general mechanism by which an FTA could have a broader influence on society. The key analytical questions for any broader statement about trade's impact on governance concern how narrow requirements that apply to a country's regulation of trade and investment could propagate throughout the government. Why would it not be possible, for instance, to have an open, transparent, and inclusive rule-making process when foreign investors are involved, but opaque and corrupt procedures for domestic investors or for other types of regulation?

One could imagine a number of hypotheses. First, it may be administratively difficult to have the same bureaucrat follow two radically different types of approach in his daily business. Second, the juxtaposition of open and corrupt practices may alter public expectations and pressures for improved governance. Third, it may be that there are reputational spillovers from transgressions in the non-trade sector to participants in the trade and investment sector (e.g. a corrupt resolution to a criminal case sours the opinion of resident investors, even if it has nothing to do with their investments). To our knowledge, this aspect of the political economy of trade agreements has yet to be fully developed in the literature.

3) The case of Peru

A) Economic history

Peru is classified by the World Bank as a "lower-middle income" country, with a per capita GDP of $3,410 in 2007. That figure has risen dramatically from the beginning of the decade, when it was just $2,080. Over this same time period, trade as a percentage of GDP rose from 27 percent to 45 percent. Peru's top exports are minerals (gold, copper, zinc), fishmeal, oil, textiles, and agricultural products (asparagus, coffee). It is a heavy importer of manufactures. The United States was Peru's top trading partner in 2008, supplying 18.9% of Peru's imports and purchasing 18.6% of Peru's exports. Peru has suffered from extreme poverty, with roughly half of the population at times living below the poverty line. In rural areas, a 2003 study reported a 76 percent poverty rate and 46 percent extreme poverty (Francke, 2006, p. 90). To put this in perspective, Peru's population was recently estimated at just below 30 million people.

Peru's history of governance has been distinctly uneven. There have been periods of military rule, most recently from 1968-1980. In the 1980s, under democratically elected governments, Peru suffered from hyperinflation, soaring poverty rates, and deadly terrorist attacks. The economic nadir came under the first administration of Peru's current president, Alan García, from 1985-1990. At its peak in 1990, inflation reached 7,650 percent.

The macroeconomic situation improved dramatically with economic reforms launched under the administration of President Alberto Fujimori. Nonetheless, difficulties with governance, corruption, and uncertainty about economic policy remained. A World Economic Forum survey on global competitiveness in 2006 listed policy instability as the most problematic factor for doing business in Peru, and "economic/policy uncertainty" as one of the top three constraints to firm investment.

As one analyst noted, by way of arguing for Peru as an interesting subject of study:

> (U)nderpinning Peru's radical swings in economic performance since the demise of the country's liberal primary-exporter model in the late 1950s has been an equally erratic pattern of shifting and contradictory development strategies. While other countries in the region have flirted alternatively with state-led and market-oriented development models...Peru did so with a vengeance. (Wise, 2003, p. 9).

In the 2006 presidential election, Alan García returned to the presidency (on a more orthodox economic platform), narrowly defeating Ollanta Humala, a populist who emphasized economic redistribution. As reported by the New York Times, "Voters (saw) the race as an unappealing choice between a former president whose first administration had been an unmitigated disaster and a former army officer who once led a military rebellion." (Forero, 2006).

It was in the period leading up to this election that Peru negotiated its free trade agreement with the United States.

B) The role of trade

Peru's trade policy over recent decades had experienced remarkable fluctuations. After a period of more liberal trade, tariffs were hiked in 1982 as the country headed into the debt crisis of the 1980s. Imports soared, exports shrank, and a foreign exchange crisis ensued under the first García presidency. At the end of President García's first term, there were 39 different tariff rates with an average level of 46.5 percent and a standard deviation of 25.7. There were additional surcharges of up to 24 percent on top of these. By April of 1990, the minimum tariff was 15 percent and the maximum was 84 percent.

In August of 1990, the Fujimori government reduced the maximum tariff to 50 percent and the minimum to 10. By September of 1990, the number of different tariff rates employed was reduced to 3 (15, 25, and 50 percent). The decreases in average tariffs are described in the table below :

Date	*Average Tariff (without surcharge)*
August 1990	38.1%
September 1990	26.3%
March 1991	16.8%
March 1992	17.6%
June 1993	16.3%
April 1997	13.5%

The WTO, in its 2000 review of Peruvian trade policies, concluded:

> Reflecting Peru's generally open trade regime, total recorded merchandise trade grew at an average annual rate of 8.5% between 1994 and 1998.... Trade in services also grew significantly driven by the economic liberalization process. ... the stock of foreign direct investment increased five-fold since 1993 thanks to the stabilization process and the establishment of a legal framework for the promotion and the protection of investment. (WTO, 2000)

This progress in trade continued in the current decade. The WTO (2007) reported that while Peru's real GDP increased at an annual rate of 4.8 percent from 2000-2006, goods and services grew at an annual rate of 8.3 percent, driving merchandise trade from 27 to 41 percent of GDP. By April 2007, MFN tariffs were 8.2 percent.

During this period of liberalization, Peru was a beneficiary of tariff preferences from the United States. The U.S. program, launched in December 1991 was initially known as the Andean Trade Preference Act (ATPA). This provided preferential access for ten years to Peru, Bolivia, Colombia, and Ecuador as a means of assistance in the fight against drug production and trafficking. (USTR, 2009, p. 3).

The Andean Trade Promotion and Drug Eradication Act (ATPDEA) was the successor legislation to ATPA. The transition between the two measures was not seamless, however. ATPA expired on December 4, 2001. ATPDEA was enacted on August 6, 2002 and the same Andean countries were designated as beneficiaries on October 31. ATPDEA was made retroactively applicable to the expiration date of ATPA.

The successor preference program had a shorter duration than the original, lasting only until December 31, 2006. Congress passed ever-shorter extensions after that to June 30, 2007; February 29, 2008; and December 31, 2008. (USTR, 2009).

Between the various preference programs on offer from the United States and goods on which the United States has zero MFN tariffs, the vast majority of Peru's exports entered the country duty free, prior to the implementation of the free trade agreement.

U.S. imports for consumption from Peru, 2006-2008

Program	*2006*	*2007*	*2008*
GSP (%)	3.0	4.7	4.6
ATPA (%)	26.5	30.1	26.0
ATPDEA (%)	27.8	27.9	28.2
MFN Duty Free	40.7	33.2	34.0
Duty Free (%)	98.0	95.9	92.8
Total value ($bn)	$5.897	$5.207	$5.840

Source: USTR, 2009, Table 2-2, p. 9.

C) The U.S.-Peru Trade Promotion Agreement (PTPA)

In May 2004, the United States launched FTA discussions with Colombia, Ecuador, and Peru (Bolivia participated as an observer). The negotiations with Peru concluded on December 7, 2005 and the agreement was signed on April 12, 2006. The Peruvian Congress approved the PTPA by a 79 to 14 vote on June 28, 2006. (USTR 2009, pp. 2, 50).

Following the United States Congressional elections of 2006, there was an agreement between the President and Congress on May 10, 2007 to increase requirements for labor and environmental commitments in FTAs. In accordance with this, the PTPA was amended in June 2007 and approved by the U.S. Congress in December 2007. It came into force on February 1, 2009.

Aside from the additional labor and environmental measures, the PTPA followed the general structure of U.S. FTAs. Peru's preferential access under ATPA and GSP was made permanent. Duties were reduced with phase-ins of up to 17 years. Beyond market access in goods (chapter 2) and textiles and apparel (chapter 3), other chapters covered rules of origin; services trade; telecommunications; customs administration; sanitary and phytosanitary measures; technical barriers to trade, electronic commerce; trade remedies; government procurement; investment; competition policy; intellectual property rights; labor; the environment; transparency; and dispute settlement. (USITC, 2006, p. xviii).

This extensive set of commitments is the norm for U.S. FTAs and illustrates why a simple model of reciprocal tariff liberalization may not adequately capture the impact of such an agreement.

In particular, some of the measures deal very directly with broader governance reform subjects. The USITC describes the investment chapter as requiring "a secure, predictable legal framework and an investor-state dispute settlement process." The transparency chapter "requires that each party make publicly available all laws, regulations, and procedures regarding any and all matters covered by the agreement" and provides for anticorruption provisions with criminal prosecution and penalties for bribery and corruption. (USITC, 2006).

In assessing the likely effects of the PTPA on the United States, the USITC found they were likely to be "small because Peru's economy is small relative to the U.S. economy, its share of total U.S. trade is small, and Peru has existing duty-free access to the U.S. market under the (ATPA)." Specifically, the USITC estimated that the growth in U.S. exports to Peru would be more than double Peru's new exports to the United States:

> As most of the effects of tariff elimination on goods are driven by Peru's removal of tariffs facing U.S. exports, ... U.S. imports from Peru may be higher by approximately $439 million, U.S. exports to Peru higher by $1.1 billion, and U.S. GDP higher by more than $2.1 billion. Only three U.S. sectors—metals n.e.c. (mainly gold, copper, and aluminum), crops n.e.c. (e.g., cut flowers, live plants, and seeds), and paddy rice—are estimated to experience a decline in output, revenue, or employment of more than 0.10 percent. (USITC, p. iii).

The $2.1 billion estimated increase in U.S. GDP would have constituted .016 percent of 2006 GDP ($13.178 trillion). A Peruvian study, in contrast, estimated that the agreement would raise GDP by 3.3 percent, largely because of increased productivity. (Morón, 2005, p. 2).

D) What did the US want in the FTA?

Before delving into the central question of what motivated Peruvians in seeking the PTPA, we can briefly consider U.S. motives. The PTPA came as part of a program of seeking FTA partners around the world. From 1995 to 2005, the United States had actively pursued hemispheric trade liberalization under a Free Trade Agreement of the Americas. As that approach faltered, the United States pursued FTAs with many of the countries of Latin America outside the Mercosur bloc. Thus, after NAFTA with Mexico, the United States pursued agreements with Chile, the Central American nations and the Dominican Republic, and then the Andean nations.

In the Andean case, the FTAs served at least five purposes. First, the United States did gain market access and there were domestic constituencies that cared about that access. Second, this helped cement an alliance with Peru. Third, there had been a longstanding goal of free trade within the hemisphere. Fourth, the United States had declared development to be an important part of its national security strategy and FTAs were considered an effective means of promoting development in partner countries. Finally, as the successor to the ATPA/ATPDEA programs, trade with Andean nations was seen as useful in combating narcotics traffic.

4) *Peru's Motivations and Interpretation*

A) Interviews

The principal question behind this study is why Peru sought the free trade agreement with the United States. This question was pursued through a series of interviews with current and former Peruvian officials as well as individuals from academia and the private sector. The interviewees were not a random sample; they were selected for their experience and perspectives on the agreement. The fruit of these interviews is qualitative, not quantitative. There was a substantial degree of consensus among interviewees about key factors driving Peru's quest for a free trade agreement with the United States and in this section these views are synthesized to construct an interpretation of the agreement and Peru's motives. The goal is to pull together common strands so as to provide new stylized facts. To the extent we accept this 'learning' version of events, it is important to note that the segments of the Peruvian electorate who were swayed by them were employing significantly lower standards of proof than those normally employed by academics.

B) Commitment Device

The most striking commonality in responses was the secondary or tertiary role given to standard market access arguments. The trade agreement was seen as playing an important role in locking in Peru's reforms. There were economic and legal reforms that accompanied the implementation of the agreement in the last year, but most respondents described the key period of reform as coming much earlier, during the beginning of the Fujimori presidency in the early 1990s. Instead, most respondents believed that the embrace of free trade with the United States would prevent the sort of economic backsliding that they saw as a recurring problem in Peruvian development.

As one means of eliciting meaningful responses about the relative importance of different motives for the FTA, all respondents were asked the question: "In ten years, if we were to judge whether the agreement has succeeded, on what grounds would we make that judgment?" Only one interviewee – in the textile and apparel sector

– suggested expanded trade flows as a principal measure. Far more common were suggestions that increased economic growth or a reduction in the poverty rate would be legitimate criteria. In follow-up discussion to this question, many respondents made clear that despite the multiplicity of factors that can drive a country's growth or poverty statistics, they saw the FTA as sufficiently central to make this a fair measure.

The key mechanism by which the FTA would achieve these results was investment. There are at least three paths by which the agreement was seen as encouraging investment. First, by embedding reforms in an international agreement, it promised a future consistency in Peru's approach to macroeconomic policy and regulation. Second, in an environment of uncertain legal rights for investors, the dispute settlement provisions of the agreement offered increased certainty. Third, export-oriented investment would face more predictable market access in both the United States market and other markets.

It is not immediately obvious why a trade agreement promises macroeconomic stability. As broad as U.S. trade agreements have been in their coverage, they do not prescribe standards for fiscal or monetary behavior. Presumably, the argument for FTA efficacy in this regard hinges on the empirical correlation between stances on different facets of economic policy. Political leaders who are concerned enough about incentives for investment to strengthen investor rights and lock in regulatory behavior are unlikely to seek to undermine the investment environment through inflationary monetary policy, for example. This is the basis of the signaling argument for FTAs, a theoretical basis for some of the investment and commitment arguments made above.

If we oversimplify and imagine only two types of government – Benign and Predatory – each will have preferences over a range of policy instruments. We could readily construct scenarios in which each type would be anxious to declare itself Benign. In the case of the Benign government, it would be honest and would wish to enjoy the benefits of a good reputation. In the case of the Predatory government, it would like to lure investment to then predate. How, then can a Benign government establish its credibility? It can undertake commitments that would be sufficiently distasteful to a Predatory government that the willingness to undertake them credibly signals the government's type.

How does this constrain future governments? It presents such a government with a difficult choice. As with the archetypal Predatory government described above, the ideal for an incoming government would be to maintain domestic and foreign investment without setting off alarms, at least for some period of time. The strictures of a high-standards FTA make this very difficult. There are fewer easy and subtle ways to transgress. The new government would retain the right to withdraw from the agreement, but to do so would send a highly visible negative signal to the world.

In the Peruvian case, many of the economic reforms – such as tariff reductions – were undertaken well before the FTA. The FTA, however, demonstrated to the world the depth of Peru's commitment to reform. The idea of governments signaling bona fides by undertaking international commitments is not new to the literature, but the Peruvian example sheds light on a number of these academic discussions. Peru completed a high-standards FTA with the United States as a core part of its recent global economic debut. One subject of inquiry in the interviews was why Peru had chosen this path over three prominent alternatives: a bilateral investment treaty (BIT); a low-standards FTA; or liberalization under the World Trade Organization.

There has been an inconclusive literature on the effect of BITs in encouraging investment. This literature, however, may have been somewhat misled by nomenclature. While it is true that bilateral investment treaties do aim to encourage investment, they are not the only such measure to aim to set rules to protect foreign investors. A principal finding of this study is that while free trade agreements nominally aim to encourage trade flows, they are very much intended to encourage investment.

The United States government, when considering candidate countries for FTAs, has in the past treated BITs as a stepping stone. The BITs covered much of the same territory as the investment chapters of U.S. FTAs and their negotiation could serve as a test of the partner countries' readiness to undertake the more extensive FTA talks. But Peru did not pursue a BIT with the United States. One well-placed interviewee explained that this would have been pointless. By the time Peru was ready to think about such an agreement, the possibility of an FTA was available. The FTA with the United States was perceived as offering all the advantages of a BIT, and more.

A second alternative would have been to pursue a low-standards free trade agreement.

There is no formal definition, but this would mean an agreement that did not require extensive liberalization and did not require the participants to undertake extensive commitments in investment and services. Such FTAs of limited scope are very common, particularly between developing nations. Peru is a member of the Community of Andean Nations (CAN) and hosts its headquarters in Lima. Peru joined the FTA among CAN members in 1997. A number of interviewees argued, however, that Peru's participation had yielded little significant economic benefit. This inefficacy might be expected on either trade or investment grounds. In trade, the other CAN members would be likely to have similar comparative advantages to Peru. In investment, partner nations such as Venezuela, Bolivia, and Ecuador have had their own recent difficulties with foreign investors and would be unable to bestow a credible seal of good behavior on Peru. This did not prevent Peru from participating in the regional FTA, but that participation was driven by very different motives than the ones driving the negotiation with the United States.

A final alternative for Peru would have been to use the World Trade Organization as a forum for committing itself to a different economic policy stance. Commitments made at the WTO would have applied to all of Peru's trading partners and would have avoided the economic distortions that can accompany preferential liberalization. Peru was a founding member of the WTO and was an early member of its predecessor, the General Agreement on Tariffs and Trade (GATT).

None of the former Peruvian officials who were asked about the WTO thought that it could have played the role they sought for the US-Peru FTA. They cited a very practical problem of timing. The current round of talks at the WTO – the Doha Development Agenda – launched in late 2001 and experienced a series of stumbles after that. A last-ditch effort to complete the round in the summer of 2008 fell apart (Blustein, 2008). Though the latest dramatic failure of negotiations occurred well after Peru's U.S. FTA negotiations had concluded, the talks had encountered serious difficulties at least as early as the Cancun Ministerial in the fall of 2003. While the former officials described Peru's good-faith participation in the ongoing WTO talks, they did not see those talks as a viable vehicle for committing to a more liberal economic policy.

The question of whether FTAs contribute to or detract from prospects for broader, more efficient trade liberalization under the WTO has been a salient one in economic discussions of plurilateral liberalization (see especially Bhagwati, 2008). A central thrust of the criticism of FTAs has been that they distract countries from the multilateral alternative. Peru clearly had limited negotiating resources, but it's very difficult to make the argument that the Peruvian government was distracted by the FTA. First, Peru remained an active and constructive participant in WTO talks. Second, there were no actions Peru could have taken to advance the WTO talks in any appreciable way. Finally, it would have been very difficult for Peru to use the WTO as a commitment device, even had there been the rare availability of a negotiating round near its conclusion. This difficulty stems from the traditional "separate and differential" treatment of developing nations under the GATT and WTO (see Srinivasan, 2000). That approach meant that WTO membership carries neither a good nor a bad economic policy connotation for developing countries, since so little is required of them by the WTO. Peru's own experience illustrates this, since the high trade barriers of the 1980s were just as consistent with GATT membership as the lower barriers of a decade later.

Further, the FTA covered issues that have been excluded from WTO talks. In the Peruvian case, the most important example is the treatment of investors, which interviewees consistently cited as an important discipline in the face of a weak judiciary. Developing country opposition has kept broad investment disciplines off the agenda at the WTO.

The question of whether FTAs impede global liberalization if we restrict our focus to the traditional exchange of market access is addressed below.

C) Trade Liberalization

If North-South FTAs are seen as vehicles for obtaining reciprocal market access, the United States' agreements throughout Latin America pose a puzzle. From NAFTA on, there have been large asymmetries in the granting of market access. On the eve of NAFTA, U.S. average tariffs against Mexico were just over 3 percent. Mexican tariffs, in contrast, were substantially higher ex ante. The same pattern held for the participants in the CAFTA-DR agreement, who largely had tariff-free access through the Caribbean Basin Initiative. As described above, it also held for Peru, which enjoyed access to the U.S. market through ATPDEA. The puzzle was how we could imagine

countries to be exchanging market access when the United States' partner countries seemed to be yielding access and receiving little more access than they enjoyed under the status quo.
One consistent response of the interviewees was that the goal of access to the United States market was an important driver for Peru. The access that Peru enjoyed through ATPDEA was seen as tenuous. Whereas the preferences had initially been granted for a lengthy period, the extensions were for ever-shorter periods and the extensions involved Congressional debates that were becoming increasingly interventionist.

It could be argued that the United States revokes preferences only very rarely. In fact, one of the remarkable features of recent partisan trade debates in the United States has been the tendency of FTA opponents to support preference programs; unilateral granting of market access is acceptable but receiving reciprocal treatment is not. Given this past behavior and the linkage between trade preference programs and drug enforcement efforts, it would have seemed that the Peruvians had little to worry about.

And yet they did worry. The Congressional debates on renewal of ATPDEA were taken very seriously. While it was true that withdrawal of preferences was rare, the recent occurrences or threats had involved Peru's neighbors, Ecuador and Bolivia.

Those actions had followed provocative incidents in which the neighboring Andean governments took actions to antagonize the United States, but Peruvians had no difficulty imagining themselves in that position after the 2006 election in which Ollanta Humala, a candidate backed by Venezuelan President Hugo Chavez, was only narrowly defeated.

Further, it is not the objective probability of ATPDEA withdrawal that mattered, but investor perceptions. Interviewees consistently argued that uncertainty over the future of ATPDEA inhibited investment in Peru. The FTA offered an end to this uncertainty.

This would seem to offer some support for the argument that FTAs are about reciprocal market access. At a minimum, though, this line of argument would require an intertemporal model. Peru perceived itself as trading current-period access to its own market against future-period access to the United States market. Alternatively, if we

are weighing a reciprocal market access explanation against an investment explanation, Peru seemed to be making market access concessions in exchange for the encouragement of investment.
As a final note on the role of reciprocal market access in motivating the FTA, several interviewees suggested that the role of access to the United States market was potentially exaggerated in the domestic debate over the agreement in Peru. Market access was seen as easier to explain to the public than other benefits of the agreement. If so, this would be entirely consistent with political practice in the United States, where FTA discussions often revolve around jobs gained or lost, despite credible USITC estimates that the agreements will have a negligible economic impact.

D) Explaining the sequence

As noted above, one of the more contentious academic debates about FTAs concerns their impact on broader multilateral liberalization. In fact, the economic analysis of FTA impacts has largely been split between static analyses, which look at trade creation and trade diversion, and dynamic analyses, which consider the political economy of the agreements and where they might lead.

The political economy analyses of FTAs feature a range of analytic approaches. Some rely upon median voter models, some on the relative power of interest groups, and some on explicit models of lobbying in policy formation. One common feature, however, is that individuals and groups within the economy have a clear understanding of how policy measures like new FTAs will affect their well-being. If we wish to predict the trade policy stance of a Peruvian asparagus farmer under this approach, for example, we need only ask whether a trade agreement would raise or lower that farmer's real income (which is very likely to be the same as asking whether the price of asparagus will rise or fall). Barring large swings in taste or asparagus production technology, the answer to this question is likely to be the same whether it is asked in the late 1980s or two decades later.

In fact, over that time period Peru went from being a country with very high trade barriers to become a country aggressively seeking opportunities to undertake trade liberalization. A number of interviews shed light on this transformation and thereby on the dynamic FTA literature. The narrative involves learning, a change in views among important segments of the population about what effect trade liberalization would have on them.

Learning

There were three episodes described as important in shifting opinion about trade: the first presidency of Alan García (1985-1990); Chile's pursuit of free trade agreements; and Peru's experience under ATPDEA. The cumulative effect was not described as an unconditional embrace of trade liberalization among the Peruvian public; the FTA with the United States was still contentious. Instead, the interviewees argued, the effect of these episodes was to persuade a sufficient part of the public and some key groups – such as some manufacturers and agricultural producers – to switch from opposing to favoring the FTA.

As described above, the García presidency of the late 1980s featured heavy state intervention in the economy and high barriers to trade. The difficult economic situation that President García inherited in 1985 deteriorated dramatically. Per capita GDP fell sharply, the poverty rate soared, Peru suffered from hyperinflation, and there was a surge in violence from the Shining Path guerilla movement. The successor administration of Alberto Fujimori adopted a more market-oriented reform program and Peru climbed out of the depths of its economic disaster. This contrast served to cast doubt on the wisdom of interventionist policies among some portion of the population. This marked a broader ideological shift that had important implications for international trade.

The second instructive episode concerned Peru's southern neighbor and sometimes-rival, Chile. By any economic measure, Chile has been one of the most successful economies in Latin America in recent decades. Since the 1970s, Chile had favored a relatively open trade policy. In the 1990s, it signed a number of trade agreements with Canada and Latin American countries, including Mexico, the Central American nations, and Mercosur. This decade, it reached agreements with Europe (EFTA in 2002, EU in 2003), the United States (2003), Korea (2003), China (2005), Japan (2007). Thus, when Peruvians looked to their most economically successful neighbor for a model of how to advance, they saw a country reaching a series of high-standard FTAs with partners from around the world.

The third instructive episode involved the ATPA/ATPDEA preferences extended by the United States. As discussed above, these preferences were ultimately seen as too temporary to provide Peru with the investment benefits that more permanent market access might bring. But, as one interviewee put it, the ATPDEA offered a taste of what free trade had to offer. It did offer significant access to the United States market and Peru experienced some unexpected successes. It saw notable agricultural gains in the export of asparagus and paprika, for example. One of the most striking aspects of those successes was that they occurred in coastal regions outside of the capital city, Lima. There was also some progress in the export of textiles and apparel. This seemed to contradict the popular belief that market successes would be limited to the mining sector and to relatively prosperous Lima, where one third of Peru's population lives.

It is this third episode that comes closest to fitting academic models of learning, but there is still a substantial gap between theory and experience. The more vague the academic model – such as one positing an unspecified reform that is assumed to have a particular probability distribution of winners and losers – the better the fit. This disconnect is perhaps to be expected. In a more fully specified model, the key determinants of comparative advantage in this setting – labor costs, climate, technology, capital, global tastes – change very little. A perfectly informed agent would have the tools available to make strong predictions about the potential of certain export sectors. That this potential in Peru was realized only after the experiment of ATPDEA seems to be evidence that some agents were not perfectly informed.

To the extent we accept this 'learning' version of events, it is important to note that the segments of the Peruvian electorate who were swayed by them were employing significantly lower standards of proof than those employed by academic journal referees. None of these episodes constituted a controlled experiment and it is not difficult to identify potential confounding factors, such as sharp movements in global commodity prices. Chile's successful pursuit of FTAs does not prove that a similar approach would work for Peru. This is part of the challenge for rigorous theoretical modeling in the presence of imperfectly-informed actors. Yet the interviewees who described the shifts were offering their interpretations of their extensive and first-hand dealings with the public on the question of the FTA.

Trade Liberalization

The questions of motive and learning addressed above are critical for assessing the systemic implications of countries' embrace of FTAs. This section has largely presented the views of interviewees about the important factors behind the pursuit of the U.S.-Peru FTA. Here, we briefly describe some of the respondents' views on the way the FTA influenced subsequent trade policies by Peru. The perceived role of the FTA and Peru's ex post actions may also shed light on the relative importance of different ex ante motivations.

One common theme among the trade policymakers interviewed was that the FTA with the United States greatly facilitated the pursuit of subsequent FTAs with other trading partners. In the wake of the FTA with the United States, Peru has been very active in pursuing bilateral agreements. Partner countries have included Canada, China, EFTA, the European Union, Mexico, South Korea, Singapore, and Thailand. The claim, by the Peruvian interviewees with extensive experience in trade negotiations, is that the subsequent agreements were made much easier by the successful completion of an FTA with the United States. They said there was sufficient similarity between agreements that the work of meeting U.S. demands left relatively little work to do with other countries. It is true that a significant number of Peru's recent FTA partners also have negotiated FTAs with the United States (e.g. Canada, Chile, Mexico, South Korea, and Singapore).

This argument that the FTA with the United States significantly cut the cost of reaching subsequent FTAs helps illustrate the extent to which FTAs emphasize matters other than reciprocal market access. Whereas chapters dealing with investment restrictions, dispute resolution, intellectual property protection, and sanitary and phytosanitary regulation might be readily copied from one agreement to another, that would be much less feasible for the treatment of market access in sensitive sectors, since the sensitivity would depend heavily on production costs which would vary a great deal among country pairings.

The breadth of Peru's network of FTAs reinforces the claim that Peru was using FTAs as a means of achieving broad liberalization and attracting investment. A principal concern of the literature on the dynamic effects of FTAs was with the decision a country might make to obstruct further progress toward liberalization once it decided it had reached some individually-optimal configuration of agreements. That kind of argument is entirely consistent with behavior that is focused on terms-of-trade and reciprocal market access. The very different motives suggested by the broad-based pursuit of FTAs would seem to pose substantially less danger of a fractured and discriminatory global trading system.

E) Effects beyond trade

Finally, there was a strong sense among interviewees that the PTPA with the United States would have an important impact on the rule of law in Peru. This hoped-for improvement would take place in an area of particular weakness for Peru. One analyst writes: "Peru stands out among the countries of Latin America for the weakness of its democratic institutions and the absence of a strong democratic culture." (Crabtree, 2006, p. 26). Dargent Bocanegra (2006) argues that the judicial system is particularly weak in Peru, a sentiment that was echoed in interviews.

> Access to justice in many parts of Peru is unavailable...The service provided is in any case low-quality, lengthy and riddled with bureaucratic red tape...norms in Peru are applied partially and inequitably. (p. 137)

Interviewees saw the prospect of improved rule of law as a major benefit of the PTPA. This would apply most directly to investors who would have access to the investor-state dispute settlement provisions of the agreement, thus effectively circumventing the Peruvian judicial system. One interviewee even suggested that some investments might be undertaken just to gain standing to operate under this alternative legal system.

But there was also a sense that the measures in the PTPA could bring progress more broadly. Just as the agreement signals a commitment to a better investment environment, it also was seen as signaling a commitment to a better legal environment more generally.

Perhaps the strongest expression of this comes from Tovar Gil (2008):

> The PTPA is not a means of bilateral tariff reductions, limited to international trade

> and its gradual liberalization. It cannot be reduced to a discussion between importers and exporters, or producers who win or lose. This view misses an essential aspect of this new international relationship: it's normative side...this is an agreement of much greater significance, that will have effects that are more complex, whose achievements transcend the realm of the strictly commercial to establish an international regulatory framework for investment and services, with its own standards and rules for international investment law.
>
> This regulatory framework, at the same time, represents a model of organization linked to a vision of a market economy....
>
> In practice, Peru's legal framework already contains the bulk of the standards required by the agreement... (but) there is a fundamental change relating to investments and investors that we must recognize ... The standards and rules of this macro regulatory framework will now form part of Peru's international obligations. The rules are not shaped through a national plan or internally, but rather transcend into a different judicial dimension, the international dimension...

The PTPA is an international agreement and, as such, Peru cannot deviate from the basic rules on its own volition, for the mere exercise of its sovereignty, unless it decides to reject the agreement, which in practice would mean exclusion from the market most relevant for Peruvian products, with all the consequences that would bring.

Tovar Gil moves back and forth between investment rules and a much broader vision of a state with a difficult history that now finds itself constrained from acting capriciously.

5) Conclusions

The results of this study suggest that the PTPA was principally seen as a means of locking in economic reforms in Peru and facilitate broader integration into the world economy. Peruvian leaders hoped to make Peru a more attractive destination for investment, both domestic and foreign. The deep integration embodied in the agreement was seen as an effective means to do this. While market access did play a role, it was not the conventionally modeled one in which countries contemporaneously exchange tariff cuts. Instead, Peru offered market access in exchange for greater certainty about the access it already enjoyed into the U.S. market.

The evidence of this paper, derived from a case study rather than broad data, can only be suggestive, not conclusive. Yet in a number of ways, Peru looks like a typical mid-sized developing country. It is a poor country with high inequality; it experienced periods of poor governance and heavy state intervention; it has relied heavily on agricultural and commodity exports; and it has enjoyed trade preferences from leading developed nations. Further, Peru's recent approach to policy has been similar to that of other prominent developing nations, such as Mexico and Chile. Thus, an exploration of Peru's motivations may have some broader applicability.

The question of motivation for a policy is important, not least because it ultimately helps shape the judgment that is rendered on that policy. If a trade agreement is presented as a means for achieving market access, exports, and jobs, it is likely to be judged on future jobs figures. One of the more striking results of this study's interviews was the extent to which Peruvian proponents of the PTPA were willing to have it judged not on its trade effects, but on its ability to address Peru's core economic challenges of growth and poverty alleviation.

A number of the responses in this study cry out for further research. In particular, the political economy dynamics by which Peruvian political support swung from backing a highly insular approach to supporting opening. Also, the extent to which legal rights and practices were seen as spreading out from the areas covered directly by the agreement to the rest of the economy merits further consideration.

The role attributed to the agreement in encouraging good governance was also particularly noteworthy. The importance of governance in fostering development and prosperity has been a strong theme emanating from the World Bank and some development experts. The difficulty is that there are relatively few effective tools available to improve governance. The Peruvian respondents in this study clearly perceived the PTPA as such an instrument.

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