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How Chile Can Make the Most of Its U.S. Trade Deal

By SEBASTIAN EDWARDS

Euphoria is not too strong a word to describe the Chilean reaction to the new U.S.-Chile bilateral free-trade agreement. Local politicians are giddy, predicting that history will divide the country into a before-the-agreement Chile and an after-the-agreement Chile. Others are already calling Chile the next Ireland.

After almost 10 years of negotiations there is ample reason for optimism. Yet absent a more serious approach to reform in Chile, the benefits now being touted may prove vastly exaggerated.

The FTA is an important step towards freer trade in the hemisphere but Chile's economic future is in no way guaranteed by it. Also needed are public policies aimed at enhancing competition, reducing bureaucracy and increasing productivity and efficiency. If such policies are not put in place, the FTA could go down in history as a largely inconsequential diplomatic exercise.

If, as is widely expected, the U.S.-Chile treaty is ratified by both congresses, all bilateral import tariffs and quotas will be eliminated, and rules governing cross-border investment and other aspects of international trade will be simplified. Ergo, Chile thinks, trade will boom.

Yet contrary to popular belief the most important barrier to Chilean exports to the U.S. has not been high import tariffs or quotas. The average U.S. tariff on the vast majority of Chilean goods is less than 4%. (Admittedly there are also quotas on some agricultural goods and textiles.) Rather, the greatest hindrance to exports to the U.S. has been geographical remoteness. Chile is one of the most distant U.S. trade partners.

UCLA economist Ed Leamer has calculated that, depending on the type of good, a distance of 1,000 miles is equivalent to having to pay import tariffs between 7% and 17%. This means that for Chile geographical remoteness can be at least as much of handicap as import duties.

"Tariff-equivalence" of distance shows that Chile is at a great disadvantage to emerging countries that are closer to the U.S., such as Mexico and even Central American nations that still don't have a free trade agreement with

the U.S.

To offset the disadvantages created by distance, Chileans will need to think globally, keeping their economy free and flexible.

Although it is impossible to reduce geographical distance, it is possible to partly offset a poor location by implementing policies that increase a country's "economic proximity" to global markets. Reducing barriers to trade, as in the FTA, is one such policy. But the effect of a free-trade agreement should not be overstated.

In a recent study called "Can an FTAA Suspend the Law of Gravity and Give the Americas Higher Growth and Better Income Distribution?" Mr. Leamer and University of Toronto's Bernardo Blum, estimated that the FTA with the U.S. will, at best, help Chile move in the "remoteness scale" from ranking 62 -- out of 68 countries in their sample -- to 59. This small improvement will still leave Chile at a great disadvantage if other measures are not forthcoming.

The notion of "economic proximity" is mostly, as Nobel Laureate economist Douglas North has emphasized, about "transaction costs." Countries with less regulation, stronger private sectors, leaner bureaucracies, less red tape, more transparent political systems and greater protection to property rights have lower transaction costs, and thus greater "proximity" to global markets than countries with distorted economies and glutted bureaucracies.

Countries that share institutional frameworks -- such as similar judiciary systems -- or have a common language are closer to each other than countries that do not. Finally, an educated work force, one that can communicate easily in the modern languages of technology, helps.

To take maximum advantage of the hard-won FTA, Chile needs to work on implementing the type of policies that will reduce remoteness. So far this idea has not been well recognized in Santiago. While Chile has a generally market-friendly environment, the government has made no progress in market reforms in the last few years.

The privatization program is stagnant, and initiatives towards reducing bureaucratic red tape and other economic distortions have languished in congress. Now there is a push for new regulations that will increase the cost of electricity. Recently enacted labor legislation has introduced pernicious rigidities into an already over-regulated labor market.

Chile's educational system leaves much to be desired. In the latest Trends in Mathematics and Science Survey's international test for 13-year-olds the country ranked 36 out of 38 nations. Much poorer countries, such as Tunisia

and Indonesia, scored higher. Granted, the government has tried to make 12 years of schooling mandatory. But teachers unions have systematically stood in the way of true curriculum reform and teacher accountability, and the political class has been unwilling to confront them. The result is that Chile's public education system remains at the back of the pack.

At the university level Chile's competitors are also far more forward thinking. Mexico's Monterrey Tech -- arguably Latin America's premier science university -- requires all graduates to be proficient in English. No Chilean university has such a program.

Mexican President Porfirio Diaz famously said "Poor Mexico, so far from God and so close to the United States!" Yet Mexico is likely to find that one of its greatest blessings in the new century will be its proximity to giant U.S. markets, allowing it to take full advantage of Nafta.

Chile has no such luck. Flexibility and modernization in the economy will determine its future.

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