CAYETANO W. PADERANGA Jr., Editor

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The Philippines in the Emerging World Environment

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GLOBALIZATION AT A GLANCE

UNIVERSITY OF THE PHILIPPINES
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THE PHILIPPINES IN THE EMERGING WORLD ENVIRONMENT: Globalization at a Glance

THE PHILIPPINES IN THE EMERGING WORLD ENVIRONMENT:

Globalization at a Glance

Edited by

Cayetano W. Paderanga, Jr.

University of the Philippines
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Preface and Acknowledgements

On December 15, 1994, the Philippines formally acceded to the World Trade Organization when the Senate ratified the Final Act of the Uruguay Round* multilateral trade negotiations. The successful conclusion of the the Uruguay Round talks pushes the world's trading nations further on the road toward freer global trade. At a time when national borders are becoming increasingly porous to inward (and outward) capital flows, the further opening up of commodity markets signals the emergence of a world environment characterized by greater international economic interdependence and competition. This intensifying global contestability of commodity and financial markets poses both opportunities and threats to open economies like the Philippines. Liberalization is a two-way street: it facilitates the entry of our exports into foreign markets even as it opens up our domestic market to foreign imports. Both ways, the competition will become progressively fiercer. In this brave new world, the fitness of an economy to survive depends upon its readiness to meet global challenges and the speed with which it adapts to the fast-changing world environment.

This book publishes 14 papers comprising the first phase of the Emerging World Environment (EWE) Research Program of the University of the Philippines-Center for Integrative and Development Studies. The EWE Program was set up at UP-CIDS at the height of the public debate regarding the ratification of the GATT-UR agreements by the Philippines. It became apparent then that a comprehensive research program which would survey the salient

*The Uruguay Round negotiations of the General Agreement on Tariffs and Trade (GATT-UR) opened at Punta del Este, Uruguay in 1986 and continued in Geneva until 1993. It was concluded with the formal signing of the Final Act at Marrakesh, Morocco in April 1994 by representatives of 120 member countries of the GATT, including the Philippines. The Marrakesh accord also approved the agreement establishing the World Trade Organization which took over from GATT effective January 1, 1995. Eventually, the governments of 123 countries ratified the WTO treaty by the time it took effect. The World Trade Organization held its inaugural talks on December 9-13, 1996 in Singapore with 128 nations participating. Prior to the Singapore (WTO) round, there had been eight rounds of GATT since it was founded in 1947 with 23 original members.

issues and developments in the emerging world economic environment was necessary for an informed public discussion and in aid of policy making. Thus, scholars from the faculty of several colleges of the University of the Philippines and guest writers from the Philippine Institute for Development Studies were tapped to conduct studies in their respective fields to address the following key questions: (1) What developments are taking place in the emerging world order? (2) Who will be affected by these changes? (3) How may we respond to these developments?

This volume is a first glimpse, as it were, of globalization from the national perspective of the Philippines. All 14 chapters were commissioned specifically for this book. Draft versions of the papers were presented during the UP-CIDS Conference on the Emerging World Economic Order held on February 29, 1996. The papers have since been revised to incorporate suggestions and comments made during the conference. The comments solicited from the conference discussants are published alongside the papers.

As convenor of the EWE Program, I would like to thank U.P. President Emil Q. Javier for his official support and personal interest in the Program. For her unstinting moral and material support for the research program and the publication of this book, I gratefully acknowledge Dr. Maria Cynthia Rose Banzon Bautista, Executive Director of UP-CIDS and our publisher. I also thank Dr. Bautista for contributing the Foreword.

As editor of this volume, I would like to thank my co-authors for joining the program and for their contributions to this volume, and our discussants for enriching the book with their alternative views. My special thanks also go to Mr. Ferdinand M. Garrido who summarized for print the panel discussions and comments and for preparing the figures, and Prof. Patricia B. Arinto, our style editor, who improved our grammar and syntax for the sake of clarity of expression. Mr. Garrido, who so eases the job of a research team leader by his very competent support as program associate, and Ms. Arinto, the other half of this highly motivated couple, make publishing a book almost painless and a joy.

I also wish to acknowledge the diligent staff of UP-CIDS: Ms. Joy Aparis for overseeing the preparations of the February conference and facilitating the turnaround of the manuscripts; Mss. Nanie Domingo, Rose Punay, and Ellen Cometa for transcribing the conference proceedings and encoding the edited manuscripts; Mr. Stretch Payawal for the layout of this volume; Ms. Bella Lucas for her technical editing; and Ms. Malu Calugay for preparing the index. My thanks also to Mr. Cris Corpuz who designed the book cover, and the staff of the U.P. Printery.

Opinions expressed herein are those of the authors and do not necessarily reflect the position of their respective organizations or that of UP-CIDS.

Cayetano W. Paderanga, Jr.
Manila, Philippines

Table of Contents

List of Figures xvii
List of Tables xix

FOREWORD xxv
Ma. Cynthia Rose B. Bautista

INTRODUCTION xxvii
Cayetano W. Paderanga, Jr.

Part 1. Overview

1. OVERVIEW OF THE EMERGING WORLD ORDER 3
Florian A. Alburo

I. Political and Economic Changes 3
II. Global Responses 9
III. Small Country Context 17
IV. Conclusion 19
Notes 21
References 23

Comments 25
Federico M. Macaranas

2. INSTITUTIONAL CHALLENGES OF GLOBAL MARKET REFORM 29
Dante B. Canlas

I. Allocation and Welfare under Competitive Markets 32
II. Fiscal and Monetary Policy 37

III. Trade and Investment Policy 43
IV. Planning and Regulation of Markets 50
V. Concluding Remarks 53
Notes 55
References 56

Comments
Merlin M. Magallona 57
Felipe M. Medalla 60

3. REGIONALISM VS. MULTILATERALISM (A Panel Discussion) 63
Temario C. Rivera 63
Emmanuel C. Lallana 66
Alfredo C. Robles, Jr. 69

Part 2. Sectoral Impact

4. SERVICES AND DEVELOPMENT IN AN OPEN ECONOMY: NONTRADEABLE SERVICES 75
Mario B. Lamberte

I. Conceptual and Measurement Issues 77
II. Performance of the Services Sector 79
III. Constraints and Policy Issues 87
IV. Concluding Remarks 103
Notes 106
References 108
Appendix 110

Comments
Vaughn Montes 117
Johnny Noe Ravalo 120

5. TRADEABLE SERVICES WITH INCREASING RETURNS: SOME IMPLICATIONS FOR LIBERALIZATION 123
Nimai M. Mehta

I. Background 124
II. Gains from Specialization and Division of Labor 126
III. Some Empirical Evidence 131
IV. Matters of Policy 133
Notes 139
References 141
Appendix 145

Comments
Gilbert Llanto 149

6. AGRICULTURE AND FOOD SECURITY (A Panel Discussion) 151
Cristina C. David 151
Arsenio M. Balisacan 161

7. LABOR STANDARDS IN OPEN ECONOMIES AND THE SOCIAL CLAUSE 167
Emmanuel F. Esguerra

I. The Economic Rationale for Labor Standards 169
II. The Social Clause Debate 175
III. Some Practical Questions 182
IV. Summary and Conclusions 185
Notes 187
References 189

Comments 191
Froilan M. Bacungan

8. IMPACT ON THE INFORMAL SECTOR 193
Amado M. Mendoza, Jr.

I. **Definition of Terms/Dimensions of Philippine Poverty** 198
II. Structural Adjustment, Liberalization and GATT-UR 202
III. What Can Be Done for the Poor During Economic Adjustment? 215
IV. Concluding Remarks 220
Notes 225
References 227

Comments 232
Rene Ofreneo

9. COMPETITIVENESS, PRODUCTIVITY AND TECHNOLOGY 235
Epictetus E. Patalinghug

I. Research on Productivity Growth and Differences 236
II. Productivity and Competitiveness 249
III. Technology and Competitiveness 253
IV. Areas for Further Research 259
References 261
Appendix 266

Comments
Linda Posadas 268
Serafin Talisayon 271

10. DEALING WITH INTELLECTUAL PROPERTY RIGHTS: THE PHILIPPINE CASE 275
Ramon L. Clarete

I. Why GATT-UR Negotiated TRIPS 276
II. An Overview of the TRIPS Agreement 278
III. Assessing the Implications of TRIPS 287
IV. Philippine Compliance with the TRIPS Agreement 292
V. Concluding Remarks 296
Notes 297
References 298

Comments
Rogelio A. Vinluan 300
Llewelyn L. Llanillo 303

11. TRADE AND ENVIRONMENT LINKAGES 307
Ponciano S. Intal, Jr.

I. Some Analytical Concepts 309
II. GATT/WTO, the Environment and the Greening of International Trade 314
III. International Trade Policies and the Philippine Environment 322
IV. Adjusting to the New Trade and Environment Paradigm 332
Notes 336
References 337

Comments 339
Antonio Laviña

Part 3. Institutional and Policy Challenges

12. ECONOMIC INTERDEPENDENCE AND MACROECONOMIC COORDINATION 345
Cayetano W. Paderanga, Jr.

I. The New Environment 345
II. Economic Coordination 351
III. Macroeconomic Coordination for the Philippines 362
IV. Recommendations 369
Notes 371
References 372
Appendix 375

Comments
Maria Lourdes A. Sereno 384
Ponciano S. Intal, Jr. 385

13. LEGAL RIGHTS AND OBLIGATIONS IN INTERNATIONAL TRADE LAW: FOCUS ON THE WTO AGREEMENT 387
Maria Lourdes A. Sereno

I. International Law in Philippine Law 387
II. International Economic Law 389
III. The Uruguay Round of Multilateral Trade Negotiations 394
IV. GATT Law: A Review of Basic Principles 395
V. The Uruguay Round Agreements 398
References 419

Comments 419
Sedfrey Candelaria

14. FEATURES OF THE EMERGING WORLD ECONOMIC ORDER: IMPLICATIONS ON GROWTH POLICY 423
Raul V. Fabella

I. Global Facts 424
II. What's In and What's Out in the Emerging World Order 442
III. Competitiveness 453
IV. Impacts on the Philippine Economy 459
V. A Question of Policy: What's to be Done? 464
Notes
References 469
Appendix 471

Comments
Emmanuel de Dios 485

About the Authors 489

Index 493

List of Figures

1.1 Growth trends in US imports from Asia Pacific and the European Community 7

1.2 Trends in non-tariff barriers: European Community, North America and Asia Pacific 7

5.1 Smithian models "A" of self-sufficiency and "B" of craft-type specialization 127

5.2 Smithian model "C" of specialization and division of labor with increasing returns 128

5.3 Smithian model "D" of specialization and division of labor with increasing returns 129

5.4 Smithian model "E" of roundaboutness 130

6.1 Trends in domestic and world prices of rice (1970-1995) 153

6.2 Summary of global and historical patterns of agricultural protection 162

12.1 Ratio of (a) exports and (b) imports to GDP in selected ASEAN countries (1980-1994) 346
(c) ratio of total external trade to GDP in selected ASEAN countries (1980-1994) 347

12.2 Selected capital flows to developing countries (1960s-1993) 348

12.3 Ratio of gross capital flows to GDP in selected ASEAN countries (1988-1994) 350

12.4 Ratio of equity market capitalization to GDP in selected ASEAN countries (1989-1994) 350

12.5 Ratio of exports, imports and total trade to GDP in the Philippines (1960-1994) 362

12.6 Ratio of gross capital flows to GDP in the Philippines (1979-1994) 363

12.7 Foreign investment inflows into the Philippines (1979-1994) 364

12.8 Interest rates in the US, Hongkong and the Philippines (1987-1991) 366

12.9 Quarterly interest rates in the United States and the Philippines, 1992 366

14.1 Philippine imports, exports and trade deficit vs. China (1990 - 1994) 426

14.2 (a) Foreign direct and (b) portfolio investments in the Philippines (1989-1994) 433

14.3 Distribution of Philippine exports and imports by major commodity group (1984-1995) 460

14.4 Direction of Philippine foreign trade by major country/region (1985- 1995) 461

14.5 Balance of trade, Philippines vs. major countries/ regions (1985-1995) 463

List of Tables

1.1	Distribution of Japanese foreign direct investments	13
1.2	Correlation of merchandise trade and FDI stock	14
4.1	Share of the services sector by group of countries (1970-1992)	79
4.2	Average growth of GDP and the services sector by group of countries (1970-1980 & 1980-1992)	79
4.3	Share of the services sector of ASEAN countries (1980 & 1994)	80
4.4	Production share, labor absorption and value-added per-worker by major sector (selected years)	81
4.5	Share of services sector in GNP (selected years)	82
4.6	Backward-forward linkage effects in the Philippine economy (1988)	86
4A.1	Services sector and subsectors	110
4A.2	Non-merchandise trade	112
4A.3	Illustrative list of accredited and non-accredited professional services	113
4A.4	Growth rate of gross value added in services (1980-1994)	115
4A.5	Responsiveness of the production of services to changes in agricultural and industrial production	116
5A.1	Average annual growth rate of real GDP	145

5A.2	Average growth rate of value-added in industry	145
5A.3	Average growth rate of value-added in manufacturing	145
5A.4	Average growth rate of value-added in services	146
5A.5	Service sector share in GDP	146
5A.6	Share in total service sector output (Malaysia)	146
5A.7	Share in service sector output (Singapore)	147
5A.8	Share in service sector output (Thailand)	147
5A.9	Share in service sector output (Indonesia)	147
5A.10	Trade services share in GDP	148
6.1	Cumulative distribution of rice imports from July to October (selected years)	153
6.2	Trends in nominal protection rates of major agricultural commodities (1970-1995)	155
6.3	Estimated effective protection rate by major sector	156
6.4	Trends in rice and corn net imports and sugar exports (1909-1995)	157
6A.1	Trends in rice domestic and border prices	165
6A.2	Trends in imports/exports tonnage and ratios of imports/exports to domestic production for rice, corn and sugar (1970-1995)	166

9.1 Annual growth rates in partial and total factor productivity in Philippine manufacturing (1956-1980) 242

9.2 Annual rates of growth of input, output and productivity in Philippine manufacturing 244

9.3 Annual growth rates of input, output and productivity in Philippine agriculture 246

9.4 Contribution of the different sources of Philippine economic growth 247

9.5 Contributions of real factor growth and total productivity growth to growth of real output 249

9.6 Indices of average labor productivity for selected Asian countries (1975-1990) 251

9.7 Real effective exchange rate indices for selected Asian countries (1975-1990) 252

9.8 Indices of the level of output per worker by industry in selected Asian countries (1986) 253

9A.1 South Korean R & D expenditures by sector (1989-1993) 266

9A.2 South Korean R & D expenditures by research institute (1989-1993) 266

9A.3 United States sources of funds for basic research by sector (1975-1984) 267

11.1 Product categories subject to eco-labelling (selected countries) 320

11.2 Indices of quality of the Philippine environment 324

11.3 Philippine exports and imports by pollution intensity 326

11.4	Pollution abatement cost ratio by sector	327
11.5	Impact of trade liberalization on the Philippine environment	329
12.1	Gross capital flows to GDP ratios in selected countries (selected years)	348
12.2	Ratio of foreign direct investment to GDP in selected countries (selected years)	350
12.3	Welfare effects of the Uruguay Round	355
12.4	Welfare effects of agricultural reform	356
12.5	Simulation results of a 50 percent increase in ASEAN trade	365
12.6	Intra-Pacific trade, 1980 and 1990	368
12A.1	Selected indicators of economic integration/ openness in ASEAN countries (1980-1994)	376
12A.2	Selected capital flows to developing countries (1960s-1993)	377
12A.3	Equity market capitalization as percent of GDP in selected ASEAN countries (1989-1994)	377
12A.4	Welfare effects of the Uruguay Round	378
12A.5	Decomposing the welfare effects of agricultural reform	380
12A.6	Philippine external trade as percentage of GDP (1960-1964)	381
12A.7	Foreign direct investment inflows and GCF/GDP ratio, Philippines (1979-1994)	382

12A.8 Interest rates in the US, Hongkong and the Philippines (1987-1991) 383

12A.9 Quarterly interest rates in the US and the Philippines (1992:Q2-1994:Q1) 383

14.1 Inflow of foreign direct investment to major regions and the Philippines (1990-1994) 431

14.2 Foreign direct investment flows to selected developing countries (1991) 432

14.3 Trends in Japanese direct overseas investment by industry and region (1990-1995) 439

14.4 Trends in share of overseas production by US, German and Japanese manufacturing industry (1985-1993) 440

14.5 In-house trade between Japanese parent firms and overseas subsidiaries 440

14.6 Long-term effects of foreign direct investment: East Asian vs. non-East Asian economies 451

14.7 Major manufacturing related costs in selected East Asian cities and Japan (1995) 455

14.8 Index of distribution related costs, Japan vis-a-vis selected Asian countries (1995) 456

14.9 Telecommunications access across selected Asian countries (1991) 458

14A.1 Inflow of direct investment to major countries/ regions (1990-1994) 471

14A.2 Imports, exports and trade balance of the Philippines vs. People's Republic of China (1990-1994) 472

14A.3 Foreign direct investment and foreign portfolio investment in the Philippines (1973-1994) 472

14A.4 Determinants of (a) US, (b) Japanese and (c) German trade flows (selected years) 473

14A.5 World Competitiveness Report (WCR) factors of competitiveness 476

14A.6 1992 WCR Survey Results by country and factor 477

14A.7 Distribution of Philippine exports by major commodity group (1985-1995) 478

14A.8 Distribution of Philippine imports by major commodity group (1985-1995) 479

14A.9 Direction of Philippine external trade by major country/region (1985-1995) 480

14A.10 Philippine (a) exports, (b) imports and (c) balance of trade vis-a-vis major trade partners (1985-1995) 482

Foreword

The last decade of the 20th century has been characterized by the ascendancy of the market in an increasingly borderless global economy. The trend toward global economic integration, brought about by the influence of market forces and technological innovations, has called into question the ability of nation-states to effectively manage their own economic affairs. In particular, governments and civil societies of developing countries like the Philippines have grappled with questions like: What does it take to be 'globally competitive'? What are the prospects and pitfalls of globalization for a small and relatively open economy and society? Is globalization the 'spectre' that will haunt us as we enter the new century?

The Philippines in the Emerging World Environment: Globalization at a Glance seeks to find initial answers to these questions. It attempts to systematically put together within the covers of a single book, papers addressing the salient issues of globalization. These studies were conducted by experts in law, political science, agriculture policy and economics who are Fellows of the Emerging World Environment (EWE) Program of the University of the Philippines-Center for Integrative and Development Studies (UP-CIDS). The editor of this volume and Convenor of the EWE Program, Dr. Cayetano Paderanga Jr. modestly describes this prodigious scholarly enterprise as a "selective exploratory survey" of the impact and implications of globalization "from the national perspective of the Philippines." In fact, this volume is a trailblazing and most welcome addition to the growing literature on this very important and complex subject matter. For if indeed globalization promises "neither unalloyed opportunity nor unremitting catastrophe," mapping out the issues in broad strokes, as this book does, is a necessary first step toward developing the strategies that will maximize our national gains and minimize our losses.

This book comes out some two years after the EWE Research Program was created amidst the public debate occasioned by the then highly controversial accession of the Philippines to the World Trade Organization (WTO). It is being launched a year after UP-CIDS held a conference on the Emerging World Order on February 29, 1996. By addressing globalization issues in a dispassionate and accessible

manner, the book will be of great help to the general reader as well as the decision maker who wants to get a good handle on the dynamics of globalization as it affects individuals, firms, and the nation. It places in perspective the recent high-profile events in national and international affairs (e.g., the Manila APEC Leaders Meeting held in November, the inaugural round of the World Trade Organization held in Singapore in December, and the World Economic Forum held in Davos, Switzerland in February this year).

The UP-CIDS acknowledges the invaluable contributions of the reactors who provided alternative perspectives and helped sharpen the analysis of the papers. We would be remiss if we do not mention the individuals who worked double time to make this book see print. Epifania Domingo, Ellen Cometa and Rose Punay transcribed and encoded the conference proceedings. Ferdinand Garrido, Patricia Arinto, Bella Lucas and May Manalang-Sta. Ana painstakingly edited the text. Zircon Nicholas Payawal laid out the pages of this book. Cris Corpuz designed the cover. Last but not least, Joy Aparis coordinated the printing of the book with the UP Press.

Maria Cynthia Rose Banzon Bautista
Executive Director
UP Center for Integrative and Development Studies

Introduction

Cayetano W. Paderanga, Jr.

BACKGROUND

The world economic environment is in flux. The opening up of national markets to cross-border flows of goods and capital has led to the globalization of economic activities and increasing interdependence among diverse economies. This globalizing trend, while initially driven by autonomous technology and market forces, has been given impetus by real progress in international cooperation both at the multilateral and regional levels. The setting up of the World Trade Organization (WTO) at Marrakesh in 1994, which marked the successful conclusion of the Uruguay Round of the General Agreement on Tariffs and Trade (GATT-UR), ushered in a broader, deeper, and better articulated multilateral trading system. During and immediately after the Uruguay Round negotiations, the European Union was established, integrating further the member nations of the European Community; the North American Free Trade Agreement (NAFTA) was signed; the Association of Southeast Asian Nations Free Trade Area (AFTA) was set up; and the Asia Pacific Economic Cooperation (APEC) forum was born.

The climate of enhanced official cooperation geared toward the liberalization of commodity trade has been accompanied by a substantial growth in the supply of external finance from private sources, especially of foreign direct investment (FDI) and portfolio flows in the form of bonds and equity. A more positive attitude toward external finance has coincided with these financial flows and the growth of financial markets in many countries.

THE CHALLENGE OF GLOBALIZATION

These two trends in the emerging world environment, namely, market-driven economic interdependence and official cooperation, demand changes in policies and structures of most countries including the Philippines. On the one hand, economies are pitted against one another in the global competition for markets and

resources. On the other hand, unilateral offers and multilateral commitments made in the spirit of economic cooperation impose limits on a country's ability to engage in strategic behavior in the pursuit of national interests. Our economic managers and actors need to fashion responses that will serve our ends even as we interact more intensely with the rest of the world, competitively as well as cooperatively.

But first, we must find out what exactly is changing in the world economic environment and how. This is not as simple as it sounds. For example, during the Uruguay Round, fifteen major topics were negotiated with varying degrees of "depth"[1] and "success."[2] In addition to tariff reductions and further market openings in traded goods traditionally covered by GATT, two areas previously exempted from GATT disciplines—agriculture and textiles—were brought under WTO auspices. Also covered were "new" policies such as non-tariff barriers, rules of origin, subsidies and countervailing measures. More significantly, agreements were reached in new topics such as trade-related investment measures (TRIMS), trade in services (GATS), and trade-related aspects of intellectual property rights (TRIPS).

The sheer number of new provisions and the complicated interrelationships among the different measures confound the policy implications of the agreements. Each new provision or binding requires corresponding adjustments. Given the various combinations of bindings, the formulation of the overall negotiating stance is a challenging task. It is therefore vital to get a full picture of the new environment before getting down to the specifics of policy and institutional responses.

Moreover, various sectors within an economy may be affected differently by the changing environment. Often, different sectors (or sub-sectors within the same sector) may find themselves on opposite sides of an adjustment policy since each policy response poses opportunities as well as threats. These contending interests complicate policy and decision making. Thus, managing the transition will be intricate. It is critical to find out how these global changes will impinge upon the economy's production and functional sectors. This will help in predicting how broad groups of the population will be affected. However, the task of identifying "losers" and "winners" during the transition is by no means straightforward.

In fine, a country may want to find out how to take advantage of the opportunities offered by the new environment and how to avoid its pitfalls by undertaking appropriate changes in laws, policies, and institutions. A country like the Philippines may avail itself of the rights, waivers or exemptions, deferrals and other leeways granted to developing member nations of the GATT en route to full compliance with the legal obligations and bindings attendant to its accession into the WTO. It may also be necessary to scrutinize the exegesis of the agreements to uncover concessions which may not be immediately apparent and to find room for maneuver.

PLAN OF THE BOOK

This volume is an exploratory survey of the emerging world order and the Philippines' place in it. It contains descriptive, analytical and policy-oriented studies that would appeal to the general reader interested in an informed discussion of globalization issues as well as policy makers and decision makers involved in charting the course of government and the private sector as they seek to navigate the new global environment. The book is organized into three parts. Part 1 contains background papers on globalization, market reform, multilateralism and regionalism. The current situation and the prospects of various sectors of the Philippine economy are surveyed by the sectoral papers in Part 2. Part 3 discusses policy and institutional responses focusing on macroeconomic coordination, legal and constitutional challenges, and foreign trade and investment policy. The highlights of these papers are briefly discussed below.

OVERVIEW OF THE EMERGING WORLD ENVIRONMENT

In Chapter 1, Florian Alburo traces the origins of the emerging world economic order to the convergence of trade liberalization, capital mobility, and cross-border technology transfer fostering greater openness and interdependence among hitherto relatively closed economies. Alburo also discusses the possibility of improved leverage for market-transformed small countries participating in a rule-based and market-driven global trading regime. He concludes that greater economic interdependence fostered by globalization will raise world welfare through the gains in efficiency and better resource allocation.

On the downside, globalization also intensifies the "symmetry of mutual injury" when rules break down and distortions are allowed to go unchecked.

In the second background paper, Dante Canlas (Ch. 2) discusses how economic policy is becoming more market-oriented, open, and flexible in the era of globalization. He reviews the evolution of market-oriented structural reforms in the Philippines, which gradually dismantled a highly-regulated, inward-looking, and protectionist regime. Greater openness has integrated the Philippine economy into the global markets even as it has increased its vulnerability to exogenous shocks. Canlas calls for continuing structural adjustments and institutional changes to prepare the economy for global competition. He also finds that there is room for government intervention to address market failure and to promote industrial policy objectives.

The political and governance consequences of supranational cooperation are explored by Temario Rivera, Emmanuel Lallana and Alfredo Robles in a panel discussion on regionalism and multilateralism (Ch. 3). Rivera surveys APEC developments, noting the contrasting styles between market-oriented "classical" capitalism exemplified by Western advanced economies, particularly the US, and the "statist" capitalism being practiced by Japan and the East Asian NIEs. He observes that the lack of strategic unity of vision among the key Western and Asian members of APEC will impinge upon the pace of liberalization and improve the negotiating leverage of sub-regional groupings such as ASEAN to the benefit of small powers like the Philippines.

Lallana raises three issues on the future of multilateralism in the Asia Pacific region, namely: governance, leadership, and security. First, will APEC be rule-based like the European Union (or the WTO) or process-oriented or consensual like ASEAN? Second, which leadership modality will prevail: hegemonic or small-group? Third, should APEC broaden its agenda beyond economic cooperation to include security concerns?

Robles discusses the problem of a "democratic deficit" which arises because multilateral commitments which have far-reaching national consequences are being decided not by the people but by anonymous (and presumably unaccountable) forces. This problem will become more acute with the ascendancy of multilateralism in the global era. Robles suggests two types of solutions to redress the democratic deficit. The first proposes a one-country, one-vote formula in the most important multilateral institutions (e.g., the IMF and World Bank). The second solution which is non-statist and bolder, is to allow participation of "authentic representatives of civil society" in international fora, such as a third chamber of the United Nations composed of NGOs and peoples' organizations.

SECTORAL IMPACT AND PROSPECTS

Eight sectoral papers discuss the dimensions of impact on the production and functional sectors of the Philippine economy. The first two chapters are devoted to nontradeable and tradeable services, respectively. A chapter discusses the impact on agriculture. (Recall that agriculture and services were subsumed by multilateral trading disciplines only during the Uruguay Round.) Labor is covered by two chapters, with the formal and informal sectors discussed separately. A chapter each is devoted to technology (which is sometimes considered a distinct factor of production), intellectual property rights, and the linkage between trade and the environment. The latter two are special topics which loom large in current multilateral negotiations. Manufacturing and capital (the two most extensively discussed topics in the literature[3]) are not featured separately in this volume. However, trends in manufactured goods trade and cross-border investment flows are highlighted in the summative papers (Ch. 12 and Ch. 14) in Part 3.

Mario Lamberte (Ch. 4) discusses the instrumental role of services in economic development. There is a growing awareness of the close linkages between services and the agricultural and industrial sectors of the economy, especially the latter. This is confirmed by input-output analysis. He notes that while the services sector is the largest and fastest growing in the Philippine economy, it is also among the least productive in terms of value-added per worker. Lamberte reviews recent market-oriented reforms which have

energized the services sector. On the basis of Philippine evidence and the experience of other countries, Lamberte concludes that further market reforms and the liberalization of foreign entry will improve the efficiency and productivity of the services sector as a result of increasing competition, capital infusion, and technology transfer.

Nimai Mehta (Ch. 5) focuses on tradeable services or the "producer services" sector. He notes that the distinction between tradeable and nontradeable services is artifactual. He found a dearth of growth in the producer services sector relative to the country's consumption or final-use services (e.g., retail trade) or the producer services sectors in other ASEAN countries. He argues that there is a strong case for liberalizing entry into producer services in the presence of increasing returns. However, in final-use services where productivity gains from extended division of labor is presumed absent, unambiguous and significant gains from liberalizing these services may not occur.

Agriculture is discussed in a panel discussion between Cristina David and Arsenio Balisacan (Ch. 6). David tackles the issue of liberalization vs. protectionism in agriculture and food security. She makes a distinction between the popular view associating food security with food self-sufficiency, and the economists' view equating food security with adequate food supply at affordable prices. David argues that protectionism is inherently in conflict with the objective of food security. Restricting food imports reduces food supply which leads to higher prices. Over the long run, protectionism misallocates resources to areas where the country has no comparative advantage, thereby leading to low growth and low incomes. (In corn, for example, increasing protectionism was accompanied by declining output.) According to David, the government's policy of keeping food prices stable at levels that are affordable to consumers and fair to producers has been undermined by periodic episodes of shortages and price instability. She attributes these failures to poor implementation and poor choice of the policy instrument itself. She concludes that the current climate of liberalization will have no impact on domestic rice prices, since the Philippines succeeded in having rice exempted from WTO bindings for the next 10 years.

Arsenio Balisacan provides an international and historical perspective to protectionism in agriculture. Historically, agricultural protection rises with economic development. At higher stages of development, consumers are less sensitive to food prices as the proportion of the consumers' budget that is spent on food declines with higher incomes. On the other hand, farmers become more sensitive to food prices as agriculture becomes more commercialized and capital-intensive. Moreover, with better infrastructure provision it becomes easier and less expensive for farmers to organize. These socioeconomic factors enable farmers to lobby for protection from competing food imports in order to ensure higher farmgate prices. But according to Balisacan, rising protectionism in Philippine agriculture is happening earlier than expected relative to the experience of a cross-section of countries. The Philippines, he notes, behaves as if it were now a Taiwan.

In Chapter 7, Emmanuel Esguerra discusses the social clause which seeks to incorporate labor standards in multilateral trade agreements. Governments of industrialized countries, along with organized labor, advocate the inclusion of a social clause in the WTO regime in the belief that global competition may lead to a worsening of employment conditions. The avowed aim of the labor social clause is to ensure that workers in exporting countries (LDCs) are not made to labor under harsh or exploitative conditions and that industries and their workers in importing countries (DCs) are protected from unfair competition. On the other hand, the governments of developing countries reject the social clause as disguised protectionism on the part of developed countries which will erode the former's comparative advantage. Esguerra also discusses some practical impediments to the adoption of the social clause such as the choice of which standards to include and the difficulty of monitoring international compliance. He concludes that the basic labor rights which the social clause seeks to standardize are already guaranteed by the Philippine Constitution and subscribed to by the government under the International Labor Organization conventions. But even if it has nothing new to offer Filipino workers, the local labor movement supports the social clause, believing that an international watchdog is necessary to ensure that the government enforces its own standards.

Amado Mendoza, Jr. (Ch. 8) is generally pessimistic about the prospects for the informal sector. He regards global trade liberalization as an extension of the structural adjustment programs of the 1980s. Reviewing the record of the 80s, Mendoza predicts that the short term costs of global market reform will likewise be borne by the poor and politically marginalized. While he grants that liberalization has the potential of raising the incomes and living standards of both consumers and producers in the long run, the informal and marginal sectors are not likely to benefit because of their lack of skills and their lack of access to productive assets. As a first step, "market-enabling" measures targetting the poor must be undertaken, e.g., the provision of quality basic education and land reform. In an era characterized by the ascendancy of the market, Mendoza considers poverty alleviation as a legitimate task of any government. This is not an easy thing to do. To master the political and technical challenges of targetting pro-poor programs, reforming governments must recognize that the poor are a heterogeneous group. Otherwise, the benefits of pro-poor programs will be appropriated by the not-so-poor or even the affluent.

The link between technology, productivity and competitiveness is examined by Epictetus Patalinghug in Chapter 9. According to him, isolating the contribution of technology to total factor productivity and growth is difficult especially in the Philippines where baseline data are either nonexistent or of poor quality. Research on productivity in the Philippines which Patalinghug reviewed consistently report disappointing findings. Output growth is attributed to the growth in input usage rather than productivity increases. At best, growth in manufacturing output is credited to technical efficiency (i.e., movements from average to best practice) rather than technological progress or innovation. Patalinghug attributes the decline in total factor productivity during the 1980s not only to the lack of innovation due to underinvestment in R & D, but also to unsound macroeconomic policies. He concludes that to achieve productivity growth, the economy must develop a broad-based "social capability" to absorb advanced technologies. Patalinghug proposes that further studies to address knowledge gaps on the relationship between technology, productivity and competitiveness be conducted at the firm, industry, and macroeconomic levels.

In Chapter 10, Ramon Clarete explains how intellectual property rights came to the forefront of multilateral trade negotiations. According to Clarete, advanced economies were behind the inclusion of IPR protection under WTO disciplines mainly because high-technology and artistic products have emerged as their global niches with the shifting of comparative advantage in the manufacture of traditional industrial products to developing countries. The avowed goals of the TRIPS agreement are to encourage innovation and to promote technology-transfer. However, innovating countries have more interest in strengthened IPR protection than technology-importing countries. While the link between IPR protection and innovation is fairly straightforward, the link between stronger IPR protection and technology diffusion has not been clearly established. Clarete also discusses Philippine initiatives toward full compliance with the TRIPs agreement. He cites potential areas of conflict, e.g., the Philippine position on the patenting of indigenous life-forms (which seeks to assign IPRs to local communities/institutions) and the Generics Law (which is seen to contravene TRIPS in some of the pharmaceuticals covered by the law). He concludes that the option to leapfrog technologically by free-riding (i.e., IPR theft or piracy) is no longer costless. What we can do is to exploit the legal flexibilities within the TRIPS agreement to our advantage.

Ponciano Intal, Jr. (Ch. 11) tackles trade and environmental linkages. The growing clout of the environmental lobby has led to a number of international environment agreements and unilateral initiatives by developed countries promoting the "greening" of international trade. Among these are the ISO 14000 product standards and eco-labelling. Developing countries are concerned that environmentalism may be used for protectionist purposes. While trade and environment issues were not negotiated during the Uruguay Round, a ministerial decision was reached, committing the WTO to high-level talks reconciling environmental protection and trade liberalization in subsequent rounds. The emergence of "green consumerism" in major export markets impinges upon the competitiveness of Philippine exports. On the other hand, serious resource depletion and environmental degradation which mark our domestic record are in themselves compelling reasons to adopt a sustainable development policy. Intal discusses market-based and institutional responses consistent with sustainable development and

their effect on competitiveness. He concludes that the best way to adjust to the new trade and environment paradigm is to pursue further market reforms that will improve the efficiency and competitiveness of the economy in tandem with policy and institutional reforms strengthening the country's environmental management capability.

POLICY AND INSTITUTIONAL RESPONSES

The last part of this volume talks about strategy. Economic interdependence and macroeconomic policy are discussed in Chapter 12. The next chapter tackles the legal and constitutional repercussions of our accession to the WTO. The final chapter envisions the future shape of the emerging world environment and how we may respond to it.

The need for economic policy coordination, specifically macroeconomic coordination, arises because of openness and economic interdependence. In my paper (Ch. 12), I discuss the trend toward global economic integration as commodity and financial markets become more integrated. There are several forms and levels of international policy coordination. Among these, I cite the record of "constrained decentralized policy making" under the auspices of the International Monetary Fund and the World Bank, the type of coordination practiced by the G-7 or OECD countries after the breakdown of the Bretton Woods system, and later arrangements such as the European Union, ASEAN and APEC. There are certain benefits and costs arising from economic coordination. Among the benefits of coordination is the rise in welfare due to increased commerce. On the other hand, cooperating countries lose maneuvering room for strategic behavior. A small, open economy like the Philippines should examine its own resources, institutions and policies and try to shape coordination agreements to suit its best interests. To this end, I propose that the government formulate a strategic agenda which will define areas we should exclude from negotiations; lobby for differential treatment under certain conditions; propose international assistance to compensate for losses arising from policy coordination; and push for the acceptance of rules which are beneficial to us.

Maria Lourdes Sereno (Ch. 13) reviews in depth the legal rights and obligations under international law attendant to our ratification of the WTO treaty which incorporates the agreements concluded during the Uruguay Round. Sereno anticipates possible conflicts between some of our treaty commitments and local law. Among these are commitments susceptible to legal challenges on constitutional grounds. She cites a provision in the WTO treaty which does not brook the unconstitutionality of a commitment as ground for non-compliance. This raises the interesting question of whether we should renege on our commitment should this be declared unconstitutional, or whether we should amend any provision in the constitution which contravenes our international commitments. Sereno states that the time for debate is over and that we need to deliver on our commitments. However, she points out that within the agreements themselves, there is some leeway for negotiating flexibility and room for strategic maneuver. She strongly suggests that we fully exploit these areas of flexibility. She concludes that the Philippines should take full advantage of the waivers, deferrals and exemptions the WTO grants developing country members and maximize the market-opening opportunities available to us under the WTO treaty.

The final chapter (Ch. 14) is an encompassing strategy paper by Raul Fabella. First, he surveys the features of the emerging world order, noting the coexistence of multilateral and regional trade arrangements promoting freer trade. Next he discusses the globalization of capital, particularly foreign direct investment (FDI), and its impact on the international division of labor. He notes that unlike the immiserizing FDIs of the past, latter-day FDIs mediated by global firms (TNCs) are trade-creating and technology-purveying. In the new world environment, trade in factors is a complement of rather than a substitute for trade in goods. According to Fabella, this renders obsolete textbook factor proportions models which assume that factors are non-traded. At the same time, the now dominant pattern of trade-creating capital flows (which is predicted by elaborate comparative advantage models) reinforces comparative advantage theory. Firms do cross borders in search of the best cost configuration. Hence, while the concept of comparative advantage is changing, it is not *passé*.

Focusing on the effects of globalization on the Philippines, Fabella documents the impact of FDI on the structure of Philippine exports and trade patterns. The share of manufactured exports has risen dramatically. At the same time, imports of capital and intermediate goods from FDI source countries are growing. Consumer goods imports are also rising as a result of trade liberalization and the strong peso. In terms of our competitiveness as a host country, the Philippines fared poorly in the international surveys cited by Fabella, particularly in infrastructure. Also, our manufacturing and distribution-related costs are among the highest in the region. How should the Philippines respond to the changing world order? Fabella suggests three policy planks. First, the Philippines should promote micro-upgrading, that is, developing technologically nimble and efficient firms. Second, we must undertake macro-upgrading which has two dimensions: sound macroeconomic policies and competitive "hard" and "soft" infrastructure. Third, we must play the "poor-country card" to take full advantage of the concessions granted developing countries in multilateral trading rules.

CONCLUSION

This survey of the emerging world environment, selective as it is, shows how rapidly international economic relationships are changing both in breadth and in depth. The papers in this volume suggest that the brave new world that is now upon us offers neither unalloyed opportunity nor unremitting catastophe. To avail ourselves of the opportunities it offers and to avoid its dangers, we must put together a well-structured response which will entail changes and demand sacrifices of all sectors.

At the same time, all the papers indicate that many of these changes are beyond our control. Avoidance does not seem to be an attractive option, even if it were possible. These changes have proceeded for some time and are continuing at an accelerating pace. The Philippines needs to shape a coherent and integrated adjustment program to keep up with these changes.

The information and analytical demands are enormous from a research point of view. Within the shortest possible time, scholars and experts must mobilize in order to forearm our policy makers with background data and analysis to inform policy and negotiating positions. As the Philippines gears up to address the emergent and succeeding challenges of globalization, more research will be needed.

The task of policy makers and the national leadership is no less daunting. It is their job to work out the necessary package of policies, legal changes, and institutional restructuring to respond to the changing environment. Finally, they will have to pass the ultimate test of national leadership: rallying our people behind the national program.

NOTES

[1]Depth means how far the negotiations delved into the topics and resulted in agreements, especially in the newer areas such as intellectual property rights (TRIPS) and trade-related investment measures (TRIMS).

[2]Success is measured by the degree to which an agreement brings the multilateral trading system *closer* (by general consensus) to freer trade.

[3]For a recent survey which depicts the deepening of market access in trade and investments in the Asia-Pacific region, see Federico M. Macaranas, *(ed.)* 1996. *APEC and the Philippines: Catching the Next Wave*. Manila: APEC Substantive Group, Department of Foreign Affairs.

Part 1
OVERVIEW

1. An Overview of the Emerging World Economic Environment*

Florian A. Alburo

INTRODUCTION

The purpose of this paper is to review recent developments in the world economic environment. The 80s and the 90s have been both settling and unsettling in terms of the rules and scope of global economic transactions. What happened during these decades has repercussions on the kind of sociopolitical environment that would appear in the next century and dictate the economy until the millennium.

Section I of this review quickly describes the economic and political changes that have taken place since the mid-80s. Global policy changes in this decade alone dictated the world economic transformation thereafter. Section II identifies the global responses that have affected the world economic environment. Section III examines some implications of the emerging economic environment for small countries. A final section draws some conclusions.

I. POLITICAL AND ECONOMIC CHANGES

A number of recent political and economic changes are reshaping in part the global economic environment. Some of these, though quite unexpected, have reinforced other changes.

First, there has been the demise of communist systems and central planning countries during the last 10 years as well as some unification of countries earlier divided by political ideologies. The Union of Soviet Socialist Republics (USSR), the rockbed of communism and central planning,[1] has disintegrated. The economic systems in Eastern Europe have adopted a clear redirection of economic philosophies. Then there was the unification

*The revision of this paper benefitted from the comments of Undersecretary of Foreign Affairs Federico M. Macaranas.

of the two Germanies as the Berlin Wall collapsed and a unified market system was adopted in the previous Eastern Germany. Antedating this was the unification of Vietnam.

The abandonment of the Communist ideology meant a lot of things. The new countries had to grapple with the basic elements and institutions essential for a functioning democracy. The capacity to bureaucratically manage market systems required undeveloped capacities and therefore entailed a global support.[2] The transition was even more difficult to manage as the trade-offs remained unclear. From the viewpoint of the West the disappearance of an enemy meant that it could free resources from defense toward alternative uses.[3] But although there were general expenditure cutbacks in the West, the matter of dealing with this was unsettling. The unification of Germany required more of West Germany in terms of the provision of development support to raise living standards, and the provision of massive infrastructure and capital toward the goal of unity. The emergence of smaller East European nations meant more challenges for political leadership via democratic means and posed an even greater danger of reverting to previous hardline ideologies.

Other breakups were not triggered by an underlying clamor for democracy nor a need for economic changes. Witness the breakup of former Yugoslavia. If anything, the Bosnian conflict is a move away from economic consolidation and threatens the stability of global peace.

On the other hand, there are pending unifications for both political and economic reasons which have yet to see the light of day. Such is the unification of North and South Korea.[4] In part this is a threat not only to Pacific (and world) security but also to the environment for the global economy.

There have also been deliberate market transformations in some countries which did not entail totally abandoning political ideologies. A case in point is the People's Republic of China where the use of incentives has been the anchor for instituting market signals. Differential wages are now based more on market considerations than on the old adage "from each according to ability,

to each according to need." Although market reforms in China started as early as 1978, economic packages were aggressively pursued in the 80s, including the establishment of Special Economic Zones, reform in state-operated enterprises, and financial reforms. The changes in China have been gradually pursued over the years (as opposed to the rapid changes in Eastern Europe) but have significantly affected the rest of the world. Its large international trade impinges on the rest of the world.[5] For example, incremental imports of food by China (due to its internal problems, for example) disturb the global markets for food. Indeed this is true of many products that China trades. The country is also a major absorber of external resources, principally foreign direct investment. In a sense, this also means that the country displaces other developing country destinations competing for scarce development resources.

The Indo-Chinese states are also on the road to market transformation, following Vietnam's reforms of *doi moi*. In fact, Vietnam's efforts are being pushed further through its membership in the Association of Southeast Asian Nations (ASEAN) which in turn provides a broader market umbrella. As the other Indo-Chinese states expand the scope of their market reforms and as they eventually become part of ASEAN in an integrated Southeast Asian region, the regional and global economic balance of power may likewise change.[6]

But in spite of the fact that the current leaders of these countries pursuing market transformation are firmly committed to its completion, shifts in political power remain a problem. There are questions regarding the fate of Chinese reforms in a post-Deng era.[7] The same is true of the other Indo-Chinese states. In a democratized system of election and selection, leadership transition becomes critical. The road to market transformation can easily be destroyed and reversals may take place. The global landscape may thus easily change even with market transformation taking place.

Whether there is in fact a specific political context for a successful market transformation remains an issue. On the one hand is the argument that economic success requires a political order (analogous to the strong rules in the Asian dragon economies) in some sequential phase. The counter-argument is that political

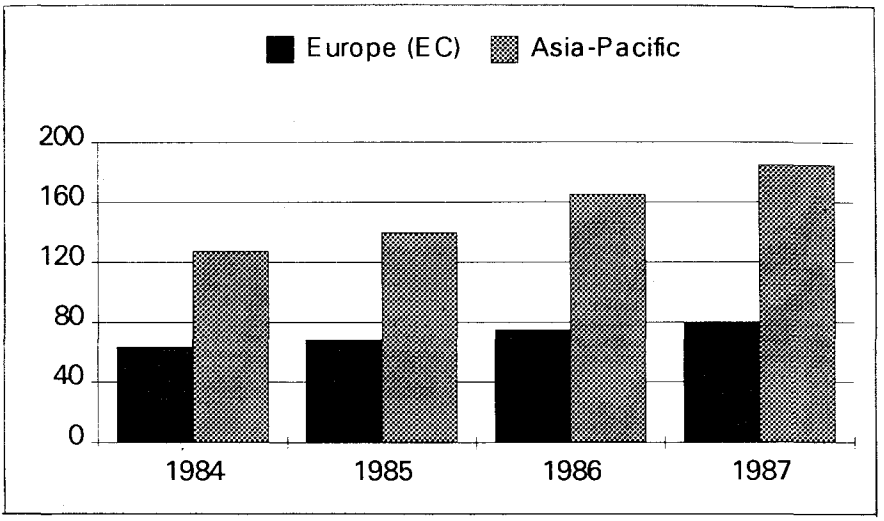
liberalization may be a necessary condition for economic success. Indeed, the fluidity of the current transformations indicates there is no resolute formula to go by.

In the 80s there was substantial liberalization of trading rules as tariffs were scaled down in the aftermath of the Tokyo Round. Yet what emerged was the more frequent use of non-tariff barriers as a means of restricting trade. There were more bilateral efforts to "manage" trade either to keep markets restricted or to preserve trade shares. One estimate in 1986 showed that about half of all commodities traded were under non-tariff barriers.[8]

The proliferation of non-tariff barriers was a manifestation of a broader breakdown of the international trading system under the General Agreement on Tariffs and Trade (GATT). For one, the agricultural sector was not part of the trading rules and this exclusion has distorted overall trade patterns over the years. Furthermore, having non-tariff barriers has made it difficult to negotiate especially at the multilateral level given the varying instruments used. Also, the tendency for major world traders to undertake trade transactions out of GATT disciplines (e.g., voluntary export restraints, orderly marketing arrangements, etc.) has stifled wide participation from developing countries. In all, despite the apparent decline in the transparent barriers to trade, the non-tariff elements of restrictions have grown — in varying degrees across the world — indicating a breakdown of GATT rules and disciplines.

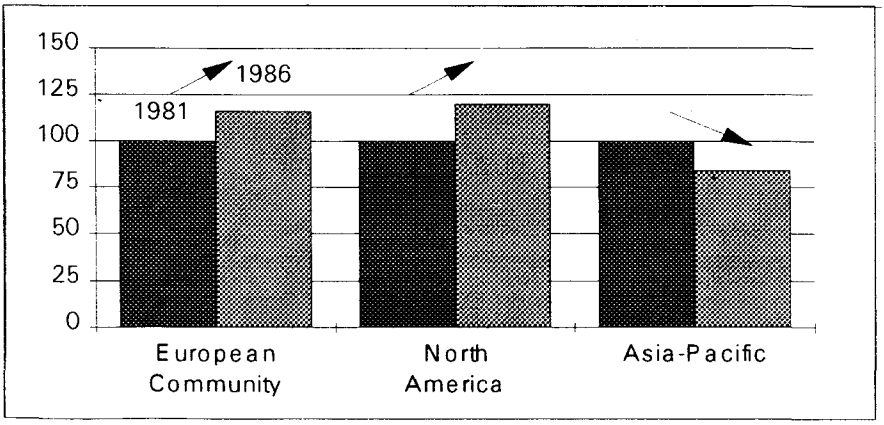
Figures 1.1 and 1.2 show the relationship between trade expansion and non-tariff barriers in the Asia-Pacific region between 1981 and the start of the Uruguay Round negotiations. Figure 1.2 indicates that United States (US) imports from the Asia-Pacific region have been increasing more rapidly relative to imports from the European Community (EC). But its trends in non-tariff barriers, shown in Figure 1.2, indicate an increasing incidence of restrictions to trade. In fact, even the EC increased non-tariff barriers during the same period and only in the Asia-Pacific region did such barriers decrease.

Figure 1.1 Growth trends of US imports from Asia Pacific and European Community (in US $ billion)



Source: Andrew Stockel, *et al.* (1990) *Western Trade Blocs.* Canberra: Australia's Centre for International Economics.

Figure 1.2 Trends in non-tariff barriers: European Community, North America and Asia-Pacific (Index)



Source: Andrew Stockel, *et al.* (1990) *Western Trade Blocs.* Canberra: Australia's Centre for International Economics.

Finally and in part because of the widespread breaches of trading rules, there have been many moves toward regionalization.[9] The United States vigorously pursued the North American Free Trade Agreement (NAFTA), an expansion of the previous US-Canada Free Trade Arrangement with Canada and Mexico. NAFTA was ratified in record time and set the trend for regional free trading. Europe pursued its own 1992 Agreement and the Maastricht Treaty, paving the way toward a kind of United States of Europe. This further regionalization within Europe has solidified the rapid dismantling of internal barriers and has resulted in almost perfect mobility of goods and factors. Economic union is now simply a matter of time.

In the Asia-Pacific region, two streams of regionalization drives are to be noted. The Association of Southeast Asian Nations (ASEAN) formalized in 1992 its ASEAN Free Trade Area (AFTA) as a program for freeing trade within 15 years.[10] This has subsequently been accelerated for completion within 10 years. The Asia Pacific Economic Cooperation (APEC) which boasts of membership from economies on both sides of the Pacific began in 1989 with a goal of greater trade liberalization. Although APEC started as a loose and flexible forum for discussing liberalization issues in the region, it soon embarked on a bold program of free trade within 25 years.[11]

There are other regionalization efforts such as the efforts of the South Asian countries. Australia and New Zealand have forged a closer relations agreement. The latter is being considered for interactions with the ASEAN's AFTA.[12]

As pointed out, the regionalization trend was a reaction to the breakdown of the international trading system. In particular, it was some kind of insurance against the risk of fallouts from the negotiations for new multilateral trading arrangements embodied in the Uruguay Round. The magnitude of the risk and uncertainty pushed the regionalization drive faster, especially as no breakthroughs in the negotiations happened past the deadline of the Round. Indeed, even the move toward AFTA was partly in response to the failure to meet the original deadline for the conclusion of the Round. There was also the fact that European free

trade was well on its way. However, although regionalization served a purpose, the conclusion of several free trade agreements also served as a threat to the commitment of the countries involved to a multilateral trading system.

II. GLOBAL RESPONSES

Our review in the previous section showed two contrasting contexts for the political and economic changes currently taking place. The first consists of the abandonment of the ideologies of communism, socialism and central planning and the shift to market systems varying in political color across countries. In contrast, the second context is the breakdown of the international market's rules and disciplines. These are contrasts because one is a reinstitution of confidence in market structures while the other is evidence of cracks in the same structures. It is interesting that these contrasting changes have occurred simultaneously, reinforcing the continued importance of a global economic system that is market-driven.

What have been the global responses to these changes? It is useful to categorize them into two major thrusts.[13] One consists of the autonomous events that have been going on under the sheer force of market mechanisms without direct policy instigation (though these may have been facilitated by policies themselves). The other consists of the responses of the global economic community to the various changes earlier reviewed. Whether these responses feed on each other or not requires some analysis and discussion.

The last few years have seen the emergence of globalization in the world economy.[14] Although confined to a few sectors such as electronics and consumer products, globalization may be illustrative of what will happen in the future on a broader scale. The globalization of production has been driven by a combination of more openness; liberal trade regimes; greater mobility of factors; and the encompassing infrastructure of telecommunications, transportation and information technology. Globalization is synonymous with a

"borderless world." There is also a globalization of consumption taking place as the reach of satellite television expands choices and makes tastes more homogeneous.

From globalization has emerged the global firm. This firm is unlike the transnational corporation which is usually large, concentrated in resources and even integrated. Now both a small firm and a large firm can actively transact in the global marketplace, whether horizontally or vertically. Economies of scale are not as important as certain other critical properties.

First, the global firm is really a network firm; that is, one whose production processes and their components are spread out globally and any one of the firms along the chain does the product completion. There is therefore a larger interdependence among the network firms. Second, it makes use of forms of firm arrangements other than the traditional equity investments. These include licensing, supply contracts, procurement arrangements, joint ventures, etc. They constitute new mechanisms through which firms operate so that even companies considered "closed" are capable of becoming network firms. Third, and related to the first two properties, is increased emphasis on coordination and a corresponding reduced emphasis on control. This is consistent with newer forms of firm relationships and the network basis of production. Indeed one result of these properties is that a global firm may not have a physical factory and yet produce a volume of output. Fourth, there is now mutuality of relationships among firms based on the assumption that all parties to the globalization process have something to contribute to production. Prior to globalization, the host firm receiving foreign investments absorbed technology, management capacities and skills but provided only marginal contribution such as unskilled labor. In a global setup relationships are two-way. Finally, while all firm sizes take part in the globalization process, firms also form groups or enter into alliances to take advantage of joint services, joint marketing and other similar economies without necessarily entering into joint ownership. In fact, competition may become more acute among groups of firms than among firms.

Although globalization is not proceeding uniformly across all industries, it is expanding from the confines of electronics and consumer products into other industries (for example, telecommunications and airlines). As technology catches up in other industries as an offshoot of globalized electronics and telecommunications industries, the globalization process will tend to become extensive as well.

One major implication of globalization and the emergence of the network firm is the declining relevance of tariffs for trading economies. Whereas previously tariffs were essential for promoting industrial processes, with a globalized firm network processes may be broadly scattered yet final outputs are accessed via trade. While in the past tariffs provided protection to products in domestic markets, with globalization tariffs no longer matter since markets are global and production takes place everywhere. Tariffs have lost their relevance especially for certain types of industries or products.

To what extent have developing countries participated in globalization? The partial available evidence indicates that an increasing number of countries now play host to global firms. In the ASEAN region for example, Singapore is host to procurement offices, assembles a wide range of electronics and consumer products, and produces specific items for assembly elsewhere. Malaysia is now the headquarters of global production of room airconditioners. Philippine firms produce computer components for Japanese multinationals yet the firms are not controlled by them.[15] There are similar arrangements in Thailand and Indonesia.

Globalization has been driven by the acceleration of trade among countries. World merchandise exports increased 9.5 percent in 1994 compared to 3.5 percent in 1993.[16] When this is viewed relative to the growth rate of world gross domestic product (which increased by three percent in 1994), it is clear that trade has indeed been expanding rapidly. The recent rise in the growth rate is higher than the average growth rate of eight percent between 1984 and 1994.

However, this is only one side of the story. Foreign direct investments (FDIs) have also been accelerating to accommodate not only the financing aspects of globalization but also their own scale of transactions. For example, the stock of world FDI which stood at US $514 B rose to US $2,378 B in 1994, indicating an annual growth rate of 11.3 percent — definitely higher than trade growth at an even shorter period of time.[17]

In the context of recent developments, it is a common observation that financial flows across the globe have in part been stimulated by trade or have supported commodities flows. Even the spurt of financial capital has been triggered by the spate of trade liberalization taking place in much of the developing world. An indirect evidence is the increasing association between trade and investment flows especially where global production exists. The magnitude and location of FDIs of global firms' parents would indicate the possible networking of firms. Japanese FDIs are hardly found in Africa, Oceania and the Middle East. This means globalization has so far been concentrated in North America, Europe, Asia (mostly North and Southeast Asia) and Latin America. (See Table 1.1) In time, the reach of globalization will expand as the newer market economies strive to be part of the networks. With advances in technology, this may happen sooner than expected.

The correlations between shares of total merchandise trade (to total trade) and inward and outward FDI stock have been found to be high. Countries in the Asia Pacific Economic Cooperation (APEC) region experienced high correlation in 1980 and even higher correlation in 1990. This is also true for the newly-industrializing economies (NIEs), the People's Republic of China (PRC), the European Union (EU) and Australia-New Zealand (ANZ). Table 1.2 reports this.

Most of the privately-led market-driven changes in the economic environment depend on institutional setting. With the implementation of the GATT-UR Agreement by members of the newly-established (1995) World Trade Organization (WTO), dramatic changes in the global trade environment can be expected. The overall trade landscape will change. The UR Agreement is perhaps the most comprehensive set of trade rules so far. It covers almost all trading

Table 1.1. Distribution of Japanese foreign direct investments (FDIs) (in percent)

	Cumulative (to March 1993)
North America	43.9
Europe	19.6
Asia	15.5
Latin America	12.0
Oceania	6.1
Africa	1.8
Middle East	1.1
	100.0
Total (US$ Billion)	386.58

Source: Adopted from Simon and Jun. 1995.

sectors: those which heretofore were excluded from the multilateral framework and those which, though administered by GATT, were actually inconsistent with GATT. In addition, the agreement sets new rules for new sectors, tightens disciplines, and removes or reduces gray areas which threaten the stability of the global trading system. Agricultural trade which was not included in the GATT rules will now be subject to transparency and liberalization in stages, and trade in textiles and clothing which was bound by the Multi-Fiber Agreement (MFA) will now be integrated into the overall trading rules over a specific period of time.

Table 1.2 Correlation of merchandise trade and foreign direct investment stock

Regions	1980	1990
Asia APEC	0.9876	0.9390
Asia APEC (excluding Japan)	0.9504	0.9747
Non-Asia APEC	0.9068	0.8494
APEC	0.9028	0.9004
EU	0.6036	0.7501
North America	0.9143	0.8441
ANZ	0.7386	0.7993
Japan	0.9658	0.9425
PRC	0.8536	0.9745
NIEs	0.9300	0.9917
ASEAN	0.9732	0.9556

Source: Industry Canada. 1995. "FDI and APEC Economic Integration," APEC Ad-hoc Group on Economic Trends and Issues (1994).

Key:

ANZ	Australia-New Zealand
PRC	People's Republic of China
NIEs	newly-industrializing economies
ASEAN	Association of Southeast Asian Nations
APEC	Asia Pacific Economic Cooperation
EU	European Union

Estimates of the macroeconomic impact of the UR[18] show that overall, the world stands to gain from the accord mainly because of the increased trade and the increased incomes it will generate. The boost to trade comes not only from more liberalized trade but also from the conversion of non-tariff barriers to tariffs.

The UR coverage is clearly across the board and not confined only to manufactured goods. In agricultural trade, both unprocessed and processed products are covered though the liberalization is in two stages. It is also inclusive of textiles and clothing. Though integration from the MFA into WTO begins with four categories of products, the manner of integration for the other categories is clearly

specified. In the case of services, the scope is defined and the principles laid out. Though the liberalization of this sector still has some way to go, the Annexes to the Agreement indicate that at least two areas — financial and telecommunications services — will lead the way in the inclusion of services in the multilateral trade framework.

In the case of industrial products, though the average tariff rates in the pre-UR period varied considerably, the commitment under the UR Agreement is toward significant declines over six- or ten-year periods. The tariff rates of industrial products of the developed countries are to fall by 38 percent. Of course their averages are already low and the absolute reductions may not be large.

Several points in the agreement on the reduction of tariffs for industrial products are interesting. One is that the specified tariff rates for most product categories of developed countries will turn out to be within the 0-5 percent rates. Another is that these reductions are to be made in five steps or by the year 2000.

Cutting across agricultural and non-agricultural trade is the programme to replace or remove non-tariff barriers (NTB). This has taken three forms: (1) conversion of NTBs on agricultural imports into tariff equivalents, and then subsequent liberalization; (2) phase out of the MFA; and (3) phase out of gray area measures. The reduction of subsidies would also remove one more significant distortion in world trade.

Many of the means used by agricultural producers to distort agricultural trade have been addressed in the agreement. The steps for transforming NTBs to tariffs are also indicated. Distinctions are made between government support that is non-distortive and that which involves transfers from consumers to producers, with stipulations that the latter is to be phased out. Once the process of conversion to tariffs is completed, these will be lowered by 36 percent for developed countries, and 24 percent for developing countries over six and 10 years, respectively.

The MFA, another persistent NTB, is also to be phased out over 10 years according to a schedule. The schedule allows not only outgrowing existing bilateral arrangements but also progressive participation by new producers. The other NTBs are to be phased out over four years. These include measures such as voluntary export restraints (VER) and orderly marketing arrangements. While the agreement allows the retention of one gray-area measure until the year 2000, it is quite clear that the rest will have to conform to GATT rules.

The two thrusts of globalization and global economic institutional reforms through the WTO appear to reinforce each other. The interactions, networks and transactions taking place among firms across borders would definitely deepen with more transparent trading rules and ever declining barriers to trade. To the extent that the UR agreements are observed by contracting parties, they will safeguard the entry of more countries into market-determined transactions in fair and non-discriminating ways.

But there are limitations on the extent to which globalization can be further facilitated. There are doubts whether capital markets are in fact globalized in the sense of similar rates of interests.[19] There are doubts about the extent of privatization taking place among countries which profess commitment. And there are doubts whether labor services move freely to equalize wages. For as long as the sectors in which global firms have evolved are expanding in inter-industry transactions, globalization is bound to influence the rest of the manufacturing and services sectors. Indeed there may emerge other combinations and arrangements for economic transactions that globalization will generate.

These two thrusts also have implications for the political and economic changes discussed in the previous section. First, the time horizon in the agreement is neither too far nor too near to create external economic shocks to the newly-emerging economies. There is enough lead time for them to seek resources for capacity buildup, provide producers incentives where warranted, and engage in market scans. The transition period will prevent severe shocks to new institutions of economic management.

Second, a reassessment of the relevance of free-trade or regional groups amidst the multilateral agreement is needed. There is no quarrel about the superiority of multilateralism relative to regionalism. At the same time, there are odd mixtures of countries in different regional groups. For example, ASEAN and AFTA members are part of APEC. That is why the original regional groups are groping for unique identities without diminishing the importance of the WTO. There is a search for "plus" elements in the regional groups that should be beyond the results of the UR.[20]

Finally, the market-transformed countries have more and better options in terms of production and trade based more on comparative advantage than on government edict. As global prices of traded goods reflect more social scarcities than underlying interventions, these countries can look forward to greater efficiency gains from trade. Internal policies may have to be relied upon to ensure that trade reflects global resource allocation.

III. A SMALL COUNTRY CONTEXT

The final shape of the emerging world economic environment has to be seen in terms of its applicability to trading countries. The evolving market forces and the impact of reforms in the trading system have inherent geographical biases. Noted above is the narrow confines of the current globalization. Our evaluation of the impact of the UR Agreement also indicates some geographical bias.[21] For instance, there is less immediate beneficial impact on Africa and the Middle East than on the Asia-Pacific and Latin America. Although these impacts are not uniform within the different regions (cf. North Africa with Sub-Saharan Africa, North Asia with South Asia) nor across the different commodities traded (e.g., primary products, textiles and clothing, cereals and meats), the positive impacts feed on the market responses that have occurred. Consequently, the environment contains an element of self-selection depending on the particular circumstances of the country. But we can assess the context and surrounding conditions for small countries in the light of the global responses that have recently emerged.

The impact on agricultural countries depends on what products are traded and whether the countries are net importers or exporters of certain commodities. Certainly, the removal of subsidies, the dismantling of quantitative restrictions, and the gradual imposition of tariffs, suggest a rise in agricultural prices. Where a small country is concerned, all these prices would be given. To the extent that its exports are in grains, dairy, sugar and other commodities heretofore subsidized, one can expect some immediate benefits. Where the country is a net food importer (as in some African, Asian and Latin American countries), rising prices would initially have adverse effects. In countries which are current producers of agricultural products subject to subsidies, the UR Agreements would benefit consumers in two ways: the reduction of tariffs via the removal of quantitative restrictions would lower prices while the removal of subsidies could lessen tax burdens. But for small agricultural countries the impact would in the long run be beneficial as adjustments take place and supply responses occur. Much depends on the adequacy of support and internal policies.

Moreover, the removal of quantitative restrictions and conversion to tariffs will have beneficial effects for particular manufactured products. These include textiles and clothing, metal manufacturers, and some core manufacturing industries such as machinery and transport equipment, including automobile products, office and telecom equipment, as well as the chemicals sector. Matching these with other countries that currently produce them would indicate the direction of the impact: Asian producers of textiles and clothing, some Latin American and West European iron and steel industries and North American producers of core manufacturing industries.

For small countries, these are not the only commodity contexts to expect. With production networks, product niches can be fully explored less autonomously and more in joint ventures with other producers. The product niches may in fact be among those with high demand elasticities ranging from consumer items to processed agricultural products.

Thus, while the extent of small country economic evolution in the emerging world environment may appear to be limited by the dimensions reviewed, the possibilities are actually large. These, however, are dictated by internal policies within the small country itself. Such policies include the degree of privatization and deregulation followed so that efficiency is maximized. The overall macroeconomic conditions are likewise important, including efforts to contain inflation and maintain competitive exchange rates. Beyond these is the support that infrastructure can give to potential producers. Indeed, for the small Sub-Saharan countries to benefit from the reforms in agricultural and industrial trade, the region's infrastructure needs to be built up. This in turn means more foreign investment (and aid) than is currently available. The more open the global economy, the greater the potential for realizing these gains.

IV. CONCLUSION

A number of conclusions can be drawn from this overview of the emerging world economic environment.

First, the dramatic changes that have occurred in many parts of the world have been caused not only by economic considerations of efficiency and welfare gains via market reforms, but also by larger political dimensions, including social demands for democratization. Political considerations also influence market processes. For instance, political conditionalities (environment, social clause) are being proposed for purely economic issues of trade.

Second, amidst these rapid changes have been two contrasting developments. One is the market-driven phenomenon of globalization. The other consists of the reforms in the international trading system through the Uruguay Round Agreement.

Third, while the market-driven responses appear along narrow sectors, the trend appears to be widening in others. Technological breakthroughs and telecommunications innovations are influencing the direction this expansion will take.

Fourth, there are now new areas for global trade ranging from services to trade-related measures and others for which the outcomes remain ambiguous. What is clear is the ever widening area for global interaction.

Fifth, the levels of participation for many countries vary, depending on initial conditions, existing capacities, and the homogeneity of economies. Small countries will take as given new parameters of global prices that result from the reforms as well as the exploitation of globalized transactions.

Finally, the emerging world economic environment underlines an even greater interdependency among the trading nations. With the addition of more market-transformed countries into the system, this interdependence is further highlighted. The interdependency appears to accord benefits to participating nations as network firms encompass more economies, as multilateral institutions safeguard fair trade, and as the world becomes more uniformly integrated. In the end these will raise world welfare through gains in efficiency and better resource allocation. At the same time, there will be a symmetry of mutual injury when distortions endanger the environment.

NOTES

[1] One reason advanced for espousing decentralization among highly centralized countries is the idea that the breakup of the Union of Soviet Socialist Republics (USSR) was caused by its extreme centralization.

[2] The International Monetary Fund (IMF) has been supportive of Russia in its reforms. But the Russian leader has also been seeking active support from other sources such as the G-7 countries.

[3] The defense aspect is not entirely dead even with these changes. Indeed, the concern now is to maintain stability through a security umbrella.

[4] The ever widening development gap between North and South Korea will probably make unification more economically expensive and politically difficult.

[5] China is now one of the largest markets for US exports and has concentrated on some industries. The latest aircraft sales have been dominated by the Chinese market.

[6] With the addition of Vietnam alone, ASEAN's market is larger than that of Europe and a number of its products are important to the world (e.g. rice).

[7] For a review of China's integration into the world economy, see Lim (1995).

[8] See the Economic Intelligence Unit (1994).

[9] See the review of global economic divisions by Soogil Young in Bergsten and Noland (1993).

[10] See the AFTA Reader (1995).

[11] See the report of the Eminent Persons Group (1995).

[12] Chee and Teh (1995).

[13] There are many other dramatic developments in the global economic environment described by Naisbitt (1994), Ohmae (1990), and Drucker (1986).

[14] This section draws from Alburo (1995).

[15] Simon and Jun (1995).

[16] The data reported here are derived from the World Trade Organization (1995).

[17] These are derived from EC-UNCTAD (1996).

[18] Economic Intelligence Unit (1994).

[19] Capital markets are far from perfect. In fact there are many countries with severe capital shortages in spite of high interest rates. This is not quite a "borderless" world in that sense. One need not point out the restrictions to factor movements, especially labor services.

[20] There are now discussions about "AFTA-Plus" and "APEC-Plus" which are really improvements on the UR for regional implementation.

[21] Economic Intelligence Unit (1994).

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COMMENTS

*Federico M. Macaranas**

My comments on Prof. Florian A. Alburo's paper are made from the vantage points of a civil servant and an economist who believes that there is a convergence of the academic and bureaucratic aspects of globalization. Let me focus on areas where I think more work can be done.

I noticed that Prof. Alburo's overview of the Emerging World Environment is heavily biased toward trade. I would like to suggest that investments be similarly treated. Statistics show that the growth of world foreign direct investment has been outpacing the growth of world exports. In the context of globalization, trade and investment issues are tied together. Where before we saw investments as a substitute for trade, today trade and investments are in fact complements. Investors do tie their activities to trade.

Translated into the language of negotiations, what this means is that we set aside for the moment WTO bindings and look instead at domestic policies which limit market access and factor movements. The fact that the movement of natural persons and business people has not yet been liberalized indicates the need for more studies in this area. In APEC, the Philippines is pushing the idea that we should treat labor as an internationally shared resource, in the same manner that capital has been so treated over the past several decades. The argument is that if you treat labor so, then the movement of human resources across borders will gain the same acceptance as capital mobility.

Prof. Alburo's paper highlighted several other observations and I will simply note certain research areas that are open for further study. One observation is that market reform is usually followed by social demands for democratization. The sequencing of liberalization, i.e., whether to liberalize the economy or the political sphere first, is an important issue. The case is often made that newly industrializing economies can afford to democratize politically only after economic gains have been consolidated. This has been the trend all over Asia,

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except for the Philippines. Singapore's Lee Kuan Yew opened the debate on this and it deserves closer scrutiny. I think the political economy approach would be appropriate here.

Prof. Alburo observed that the shift to market systems following the collapse of socialism and the demise of central planning was accompanied by the breakdown of international market rules and discipline. I find this a very interesting conjuncture. Is it because Schumpeterian forces are at work or are Marxian forces seeding the breakdown of the market? We cannot say that Marxism has been completely set aside. It remains a legitimate intellectual tradition that cannot be isolated from today's realities (as market-based economic reforms being followed through in China, for example, are based on socialist tradition).

Another observation is that technological breakthroughs and telecommunications innovations are shaping the direction of market-driven responses. We know telecommunications is shaping the world economy today just as defense technologies did after World War II. Technological breakthroughs also herald the emergence of intellectual property rights (IPR) as an important issue. This issue is potentially contentious for a developing economy like ours, particularly in the patenting of life forms that are crucial to agriculture and fisheries. The philosophy of a common human heritage is giving way to an atomistic definition of property rights, and I think this is a legitimate research issue. The Philippine position on IPR in the Asia Pacific Economic Cooperation (APEC) argues in favor of granting royalties to indigenous tribes for pharmacological knowhow which heretofore has been extracted free of charge by modern pharmaceutical companies.

Prof. Alburo also noted the widening area of global contestability not only in commodity trade but also in the area of services where global rules are likewise evolving. APEC recently held a conference on the global contestability of markets which I think goes to the heart of globalization. In the Association of Southeast Asian Nations (ASEAN), we are considering seven service sectors for negotiations and there will be some definitive action in some areas by next year. In contrast, there are only four areas being considered in APEC but there are overlaps in telecommunications, energy,

tourism and finance. Let me note again that this early we are pushing for the liberalization of the movement of businessmen and professional people.

On the matter or the varying levels of participation in the global economy particularly for small countries, I find again that the discussion is constrained by the focus on trade. I think that investments deserve more focus. Singapore, Brunei, and New Zealand, though geographically small, are definitely not small in this regard. We should describe the small country phenomenon not only in terms of the traditional macro variables but also in terms of standards that policymakers can have a handle on like investments in particular industries.

Prof. Alburo concludes that greater interdependence among trading nations would increase global welfare through the efficiency gains of a better resource allocation. I believe that distribution—who gets what—is a key issue in development economics. In 1980, the World Development Report noted that about 800 million people lived in absolute poverty and that there will be more than one billion of them by the end of the decade. Poverty is still very much with us today. This suggests that distribution issues are very relevant, and indeed we must look at how liberalization strategies have failed to advance us in this area. The human development index developed by the United Nations allows a closer scrutiny of the non-economic variables of development. I note that the Philippines is fairly well advanced in the use of non-economic indicators, but we must take a second look at these in the context of globalization.

2. Institutional Challenges of Global Market Reform

Dante B. Canlas

INTRODUCTION

One of the important structural changes of the last ten years is the adoption by several developing and centrally planned economies of market-oriented policy reforms. This worldwide reform process has had far-reaching implications, including the overhaul of social, political and economic structures within countries, along with the reformulation of institutional arragements governing international and regional relations among developed and developing economies.

The Philippines is one of many developing economies that in recent years have been relying more on the coordinative ability of competitive markets guided by a decentralized price system. The government under the Aquino administration, for instance, dismantled agricultural marketing boards that used to monopolize sugar and coconut trading. Under the Ramos administration, several big-ticket public enterprises have been privatized, including Petron, a company engaged in the refining of oil and distribution of refined petroleum products, and the Philippine National Bank. Telecommunications has also been deregulated, diminishing the market power of the Philippine Long Distance Telephone, the dominant phone company.

The Ramos administration has also unilaterally put in place a profound tariff reduction and import liberalization program geared for long-term industrial restructuring. By the year 2004, there will be a uniform tariff of five percent as provided for under Executive Order (EO) No. 264. Meanwhile, the government continues to liberalize direct foreign investments by expanding the areas eligible for a hundred percent foreign-equity participation. Two bills — one seeking scrappage of Negative List C in the Foreign Investments Act of 1991 and the other calling for the liberalization of retail trade — have been filed.

With these reforms, Philippine economic relations with the rest of the world have moved toward greater openness. The country has joined both the ASEAN Free Trade Area (AFTA) and the Asia Pacific Economic Cooperation (APEC). In 1994, the Senate ratified accession to the General Agreement on Tariffs and Trade or GATT-Uruguay Round.

Under the Common Effective Preferential Tariff (CEPT) of the AFTA, the member-countries of the Association of Southeast Asian Nations (ASEAN) are committed to reducing their tariffs to between zero and five percent by the year 2004. Meanwhile, the APEC envisions free trade among its 18 developed and developing member-economies by the years 2010 and 2020, respectively. The ratification of the GATT-Uruguay Round made the Philippines a founding member of the World Trade Organization (WTO), under which member-countries accord each other most-favored-nation status.

These policy reforms depart drastically from the restrictive trade and industrial policies pursued after World War II under an industrialization strategy based on import substitution. Domestic companies were encouraged to manufacture import substitutes and protected from foreign competitors by high tariffs and quantitative restrictions (QRs). But the policy measures in support of import-substituting industries ran counter to policies for macroeconomic stability and gave rise to chronic imbalances in both the internal and external accounts of the economy. Special fiscal incentives such as tax holidays and subsidized credit were conferred on industries selected for promotion, causing huge government budget deficits that were readily accommodated by the monetary authority. Thus, inflation persisted and balance-of-payments crises erupted periodically, impeding the transition from an agricultural to an industrializing economy.

In time, policy makers had to abandon import-substitution. The protected local industries failed to generate foreign exchange large enough to finance growth and development. Meanwhile, the flow of official development assistance (ODA) on which the Philippines greatly depended for project and technical assistance after World War II, slowed down, with economies less developed than the Philippines staking a bigger claim on foreign aid. Faced

with a continuing foreign-exchange constraint, the Philippines demanded new trade policies from developed countries to raise the necessary financial resources for the desired industrial transformation.

For the country to get the most from the liberalization of foreign trade, a wide-ranging set of economic policy reforms should be adopted. The decision to shift to a more market-oriented economy entails major institutional changes, or a revision of what Douglas North[1] calls the rules of the game. The changes apply to national economic policy and to the legal, judicial and administrative rules and structures governing market exchange, contractual performance and resolution of contractual disputes. The currently popular notion of "reengineering the government and professionalizing the bureaucracy" is one of the institutional reforms and challenges mandated by the shift to a market-friendly environment.

In making policy adjustments and institutional changes, the strengths and weaknesses of markets and the costs to agents and organizations of using markets must be weighed. Many of the existing institutional arrangements, as Ronald Coase puts it, are efforts to economize on transaction costs.

In the next section, the workings of competitive markets and various institutional responses aimed at achieving efficient market outcomes are reviewed. Institutions and rules do not emerge randomly; nor are they unilaterally imposed on society. With the adoption of a market-oriented policy agenda, the institutional structures and rules of the game evolve to facilitate the matching of individual preferences and production opportunities. This is the organizing framework, my proposal on how the issue of "institutional challenges to the emerging world economic arrangements" should be approached.

I. ALLOCATION AND WELFARE UNDER COMPETITIVE MARKETS

The analysis of how competitive markets coordinate a number of interdependent activities has been undergoing refinements over a long period of time. The usual point of departure is the observation that markets normally do a good job of balancing what buyers want and what producers seek to sell. Buyers, on one hand, have preferences over combinations of goods and services whose prices they cannot control and they choose the most preferred combination given time and money-income constraints. Decisions on how they allocate their time over earning and non-earning activities determine the size of their money income and the command they have over the goods and services in the economy. Sellers, on the other hand, face a production technology and choose from an array of factor inputs with given prices. At some price combination, a balance is achieved whereby buyers find that they are able to satisfy their wants while sellers are able to make profits on the goods they produce. If markets are complete and competitive, society's overall welfare tends to be maximized at that balance.

This market balance, however, can be disturbed. The price of one commodity relative to others may go up, resulting in a revision of the buyers' consumption and sellers' production patterns. Suppose, for instance, that bad weather destroys rice crops and the resulting scarcity causes the price of the commodity to rise sharply. Though a whole range of consumer responses can be expected when the relative price of a commodity goes up, a well-observed reaction is for consumers to economize on their intake of that commodity. As a result of the rice price increase, some consumers may not be able to satisfy in the short-term their full requirements of the commodity. Other consumers may permanently shift to some rice substitutes like bread, freeing up an additional supply of rice. At the same time, a rice price increase induces a positive supply response from farmers, enabling the previously rationed consumers to get back to their rice demand curve. Such is the strength of the market that it can be relied on to balance the needs of buyers and sellers even for a basic commodity like rice.

Under the existing institutional arrangements for rice trading in the Philippines, this coordinative ability is not greatly appreciated. The buying and selling of *palay* and rice is not fully determined by the market. The National Food Authority, a government agency, intervenes in the domestic marketing of rice and has monopoly powers over rice imports. The recent disturbance in the rice market poses an institutional challenge, given that government intervention in rice trading and importing has yielded undesirable results.

Generally, some form of non-market allocation is resorted to when the market yields undesirable outcomes. The allocation may be taken over by government or by other social institutions that have evolved in response to some needs that the market cannot meet. There are areas where government intervention is warranted, an issue we will elaborate on later.

To continue our exploration of how markets function, we now proceed to how risk and uncertainty are dealt with.

Risk and Uncertainty. Risk and uncertainty generally arise from an absence or lack of information to guide buyers' and sellers' decisions. Kenneth J. Arrow (1971) points out that the market response to an information problem is to make contracts contingent on the occurrence of a particular state of nature. Some real-world examples are the various life and non-life insurance markets.

It is in the interest of insurance buyers to protect themselves from unfavorable states of nature such as theft, fire and other accidents. People are willing to pay a price—the insurance premium—to be protected against an adverse state. On the other side of the market, there are individuals who find it profitable to provide the desired protection. An insurance contract is thus written, spelling out the terms and conditions under which the insurer pays if a particular state of nature occurs. But insurance markets are limited in the sense that not all insurance contracts offering protection against all possible adverse states of nature can be written. An absent insurance market reduces opportunities for mutually beneficial exchange, raising the question of whether government should intervene by providing for one where none exists.

There is one type of information problem that prevents an insurance transaction from taking place and for which even government intervention is not advisable. At entry level, the insurer has no way of distinguishing by risk type potential buyers of insurance. If the insurer can sort, then it will charge a higher premium of high-risk individuals than of low-risk types. If it charges a uniform premium rate, only the high-risk types apply. Adverse selection among buyers of insurance is induced, reducing the expected profits of the insurer. Normally the transaction cost of distinguishing by risk types is high and it is a cost that the insurer has no incentive to shoulder. In effect, it is in the insurer's interest not to write the insurance contract. By eliminating an opportunity for a mutually beneficial transaction, such market failure diminishes society's welfare. But since the root cause of the market failure is inadequate information which even the government is in no position to provide at a lesser cost, government intervention is ruled out.

Another case of limited information which can impede the formation of an insurance market relates to the inability to ascertain whether or not the occurrence of a particular adverse state of nature is due to a genuine accident or to a willful act on the part of the insured. In case of a fire, for instance, the question is asked whether the event was caused by arson or a real accident. In the insurance literature this problem is referred to as a "moral-hazard" problem. In general, an insurance scheme weakens the incentive to protect oneself against some adverse outcomes. This tends to reduce the profits of the insurer, effectively blocking the emergence of a complete insurance market. In this case again, the government does not possess any comparative advantage in resolving the information problem. In fact, to address moral-hazard problems the market itself institutes mechanisms like partial coverage and co-insurance schemes.

The situation just cited illustrates that some problematic market outcomes are rooted not only in the absence or lack of information but also in the unequal distribution of information between buyers and sellers. The inequality or asymmetry of information occurs in several market situations and is more pervasive than commonly thought.

George Akerloff (1970) has examined the implications of asymmetric information in the market for used cars. His most popular finding is that only lemons get traded when the seller is better informed than the buyer about the quality of a second-hand car. This is a case of adverse selection. Unequally distributed information can yield inferior market outcomes. The challenge is how to design mechanisms that tend to correct such inefficiencies.

The credit market is also not immune to this information problem. Potential borrowers differ in their probability of repayments. Some have a high default probability while others have a low default probability. If the lender can segregate the high-risk borrowers from the low-risk ones, then different interest rates can be charged. But the cost of extracting this information may be prohibitively high. The result is that lenders simply charge a uniform interest rate and some borrowers are rationed out of the market with the use of some market filters like credit investigation.

Market outcomes of this nature are not desirable. Limited and asymmetric information, along with the high cost of obtaining relevant information, may result in market failure. Moreover, corrective mechanisms may warrant some public or collective action. To explore this issue further, we now turn to externality and public goods and how these lead to undesirable market behavior.

Externality and Market Failure. Externality arises when the actions of an individual, whether to consume or produce, affect other individuals. Negative externalities are indicated, for example, in smoking, which may irritate non-smokers; or in cement production, if it pollutes the environment. On the other hand, an individual who decides to plant a tree creates positive externality if the tree provides shade to other people.

No price is paid for polluted air, shade and other externalities. The smoker and the cement producer, for example, assume the market prices of the cigarette and the cement inputs only, respectively; there is no market that assigns a price to polluted air. Such a market does not exist because it may not be technically possible to sort clean and dirty air or it may be very costly to channel the intake of polluted air

only to the agents causing it. In the absence of a market for these negative externalities, the polluter underestimates the true social costs of his or her actions and the outcomes are oversmoking and excessive cement production.

Similarly, because there is no market for positive externalities, the benefits from the shade of a tree cannot be priced. Since the tree planter cannot charge an amount to capture the extra benefits that spill over to other people, the incentive to plant more trees is dampened and society's welfare may suffer from an underprovision of trees.

Public Goods. A unique type of externality arises in the case of public goods wherein consumption by one person does not preclude consumption by others. Examples are national defense and police protection. Once these goods are provided to one citizen, they must be provided to all. Because of this inability to exclude, markets that assign prices to these goods do not exist. Pricing requires that non-buyers be excluded from enjoying the product.

Pricing is difficult in the case of public goods because people will not reveal the amount they are willing to pay to enjoy the service. If a person is asked whether protection from external aggressors or from criminals is desirable, the answer is in the affirmative. However, the same person will not quote the price s/he is willing to pay to have the service for fear of being taxed accordingly. To resolve this market failure, the state steps in and provides the service through a tax and expenditure scheme.

Imperfect Competition. In some markets, the number of buyers and sellers is small and there is no force that drives the system to a competitive market outcome. The resulting allocation of resources may be inefficient and unequal.

The most prominent case is monopoly, where there is only one firm in an industry with the power to dictate either the price or the amount to be supplied. Monopoly can arise from ownership of a unique factor of production or technology over which the firm has patent rights. This can effectively block the entry of competitors. To

prevent the monopolist from amassing excessive rent or profit, the government regulates the activities of the monopolists, including putting a cap on rate of returns.

In some cases, a monopolist faces indirect competitors who produce substitute products. Real-world examples are the many brand names for various consumer products. The situation is called monopolistic competition. As the number of producers increases and the products become close substitutes, the resulting allocation approximates a competitive one.

II. FISCAL AND MONETARY POLICY

We have described in the preceding section how a decentralized price system operating in competitive markets guides resources to their most valued uses. The price system signals which commodities are getting scarce and in so doing, induces producers to respond. Price signals, however, can run into some interference. For instance, inflation confuses buyers and sellers. For inflation to be stopped its root causes must be understood. This leads us to a discussion of fiscal and monetary policy.

Fiscal policy refers to all government revenue and expenditure measures that determine the budget deficit and the level of the public debt. Monetary policy consists of all actions affecting the money supply and the composition of the public debt. The fiscal authority consists of the Chief Executive and Congress. The former proposes the national budget and the latter enacts the General Appropriations Act. The monetary authority is the Monetary Board of the Bangko Sentral ng Pilipinas (BSP).

For several years now, the consolidated public sector account has been in deficit. A deficit arises when expenditures exceed revenues. Any deficit of the government has to be financed by taxation which takes the form of either an income tax or an inflation tax. When the government borrows from the public by issuing treasury bills to finance a deficit, it merely defers collection of an

income tax to a future period. If the government borrows from the BSP to finance the deficit, that leads to money creation, which means levying an inflation tax.

Inflation has fiscal roots. Recognizing this, planners in government have instituted fiscal and monetary policy reforms to keep inflation at a single digit. To remove an inflationary bias in the conduct of monetary policy, the government introduced an institutional reform aimed at making the monetary authority independent of the fiscal authority.

On the revenue side, the government is in the process of reforming the tax structure. Tax rates are being reduced while the tax bases are being broadened. This is seen, for example, in the value-added tax (VAT) and its recent expanded version. The VAT and expanded VAT replace a variety of sales and percentage taxes, reducing the average indirect tax while increasing the coverage. Tax administration is also tax policy. In this connection, institutional reforms at the Bureau of Internal Revenue (BIR) have been taking place, foremost of which is the computerization of the BIR. Meanwhile, in order not to compromise tax collections as tariffs are reduced, the government is proposing an equivalent increase in the indirect tax for some products. This applies, for example, to motor vehicles, crude oil and refined petroleum products.

On the expenditure side, the government continues to implement the Attrition Law to reduce spending for personnel services. A bill on right-sizing the bureaucracy has been filed in Congress to prevent excessive expenditure for personnel salaries and other compensation. Moreover, under the Local Government Code, the national government has been devolving to local government units some activities in health, social work, agriculture and public works, at a money cost equivalent to 40 percent of its total internal revenues.

The institutional challenge posed by these fiscal reforms involves strengthening the coordinating mechanisms among executive agencies responsible for budget preparation. This is being done by the Development Budget Coordination Committee (DBCC),

an inter-agency committee of the NEDA Board which coordinates the formulation of the annual program of expenditures and revenues of the national government.

The starting point is to have a consensus forecast on a number of key macroeconomic variables. The National Economic and Development Authority (NEDA) is responsible for forecasting the real GNP (gross national product) growth and inflation rates based on the consumer price index. The Department of Budget and Management (DBM) and the Department of Finance (DOF) then draw up the aggregate program of expenditures and revenues, respectively. The deficit is determined and its financing agreed upon in the DBCC. To make sure that the deficit target is consistent with inflation targets, the BSP participates in DBCC deliberations. The BSP picks up the NEDA, DBM and DOF estimates and uses these to prepare the monetary program which spells out the growth of money supply.

To raise the capacity of the BSP to stabilize prices, an important institutional reform was undertaken in 1995. The establishment of an independent central monetary authority removed a built-in inflationary bias in the conduct of monetary policy. Prior to the creation of the BSP, the Monetary Board of the former Central Bank of the Philippines (CB) was dominated by members of the Cabinet sitting in an ex officio capacity. Thus, the CB tended to accommodate whatever deficit the fiscal authority created. To avoid the political cost of raising taxes to finance the deficit, the CB's money-creation power was resorted to. The arrangement led to a large public debt, high inflation rates and recurrent balance-of-payments crises.

Large increases in money supply triggered inflation. That reduced the relative prices of imports and induced an increased demand for US dollars and other hard currencies. As a result, the foreign reserve assets of the CB were eroded. As the budget deficits persisted, additional pesos were injected into the system. Peso holders made a speculative bet against the CB that the fixed exchange rate could not be maintained. The CB failed to withstand the speculative attack on its foreign reserves. When foreign reserves fell to a critically low level, the CB devalued the peso and then ran to the International Monetary Fund to bail it out of its liquidity crisis.

The series of devaluations bloated CB liabilities. The CB could service those liabilities by generating surpluses, but all central banks derive surpluses mainly by invoking their monopoly power over money creation. There is an incentive-incompatibility problem in this arrangement. To remove it, the CB was overhauled. The newly created BSP now has a seven-man monetary board drawn mainly from the private sector. Only one Cabinet member occupies an ex officio position. The liabilities of the old CB were transferred to a new body, the CB-Board of Liquidators, whose main task is to service those liabilities using surpluses of the national government.

New Institutional Challenges. In the past few years, the Philippines has succeeded in keeping the inflation rate at a single digit. However, the challenge is to enter a permanently low inflation rate regime such as the four to five percent inflation rate that some of the country's ASEAN neighbors have.

Inflation is traceable to either a relative-price shock or a macroeconomic shock. To minimize relative-price shocks or unanticipated price increases arising from specific commodity markets, efforts at deregulating and liberalizing markets must continue. For example, the oil-industry deregulation must be put in place soonest to avoid overconsumption of oil and petroleum products. Policies governing domestic trading and imports of rice must also be reviewed. In general, if prices are permitted to perform their task of coordinating supply and demand factors, prices tend to be stable.

Macroeconomic shocks can be avoided under a set of rules that Milton Friedman first proposed and Robert Lucas reiterated. The four rules are: (1) a fixed money growth based on the demand for real cash balances; (2) a pattern of government expenditures that may grow over time but not in repsonse to business cycle changes; (3) tax rates that may also increase over time but not in response to cyclical changes; and (4) respect for wage and price agreements reached privately.

The recent reform of central banking is consistent with these rules. For the BSP, the challenge relates to the conduct of monetary policy in an open economy with capital mobility and flexible exchange

rates. Shifts in money demand are more pronounced under this policy regime, and the challenge is knowing the timing and the degree of the shift so that the money supply growth can be adjusted accordingly. Recent innovations in the banking system and in the capital market in general also have implications on the demand for money. The new savings and risk-bearing instruments being introduced by new entrants in the banking system may have money features and hence a bearing on the effectiveness of monetary policy.

The effectiveness of monetary policy rests on the smooth functioning of the capital and financial markets. BSP efforts to control money supply through open-market operations may be thwarted if there are ceilings on interest rates, since market agents can refuse to hold the debt instruments of the government. Under the current BSP policy stance of targetting mainly monetary aggregates rather than interest rates, it is important therefore for the capital and financial markets to be fully liberalized.

Moreover, the government must be careful when intervening in the credit market. Though credit rationing is pervasive, it does not necessarily follow that government correction is warranted. Many of the information-related problems resulting in limited credit markets are immune to government correction. This is one reason why several of the previous credit relending programs of the government were not fully utilized, and when availed of led to low repayment rates. With easy credit, overall liquidity targets by the monetary authority are at high risk of being exceeded. The challenge, therefore, is to define the appropriate government intervention in the credit market.

The personal, business and excise tax reforms that have been submitted to Congress can go some distance toward preventing macroeconomic shocks. With the simplification of tax administration and the broadening of the tax base, the target balance in the consolidated public sector account has a high probability of being met and sustained.

The coordination of government expenditure and revenue programs at the DBCC must continue. It ensures that priority spending programs as spelled out in the medium-term development

plan get their warranted budgetary increases without impinging on the balanced-budget objective. The coordination between Congress and the Executive on the budget process must be improved to make sure that congressional revisions are all consistent with national development priorities and the budget gets balanced in the medium-term. Meanwhile, the need for a multi-year budgeting indicates another challenge. The increased participation of the private sector in the infrastructure program of the government made possible by the Build-Operate-Transfer (BOT) Law has given rise to contingent liabilities and other guarantees for allocating risk-bearing that should be spelled out in a multi-year expenditure plan. Administrative and legislative changes are needed to bring about a multi-year budgeting process which is akin to the medium-term public investment program that the NEDA prepares. The required institutional refinement is a strengthening of the links between the NEDA's capital programming activities and DBM's related budget functions.

At present, the issuance of wage orders by the Regional Tripartite Wage and Productivity Boards (RTWPB), a mandate given to them by the Labor Code, continues to be a source of macroeconomic shocks and inflation. Although regional wage orders are superior to a nationally legislated minimum wage, given the differences in cost conditions and living standards by region, they are still less efficient than wage agreements reached privately at the firm level. The challenge is how regionally set wages can approximate market-determined wages. This may be done if the RTWPBs pay more attention to the productivity aspect of their mandate. If the RTWPBs can generate information on productivity, then they can equate administered wage increases with the rise in productivity, thereby avoiding inflation. The problem is the high cost of generating the information on productivity improvements. The RTWPBs still have to show that they have a comparative advantage over private firms in generating this type of information.

The objective of macroeconomic policy is to provide a stable environment for the private sector. Macroeconomic policy shocks or unanticipated fiscal and monetary policy measures should thus be avoided. Many of the observed undesirable business fluctuations are traceable to discretionary macroeconomic policies. Expansionary fiscal and monetary policies designed to counter a

downswing in the business cycle, for instance, generally yield temporary output and employment gains at the cost of permanent inflation. In contrast, if the recommended policy rules are observed, a stable price regime has a good chance of being ushered in. With inflation tamed, the price system is able to direct resources to their most valued uses and sustained growth of output and employment can be expected. This is the major challenge that planners in charge of fiscal and monetary policy are faced with: shepherding the economy to an efficient and stable growth path.

III. TRADE AND INVESTMENT POLICIES

Many of the welfare-enhancing policy adjustments to be undertaken are internal. However, additional welfare is sure to be generated by greater exposure to international trade. In Section II above, we discussed the significance for welfare of having complete markets: absent markets mean that opportunities for mutually beneficial transactions are forgone. By liberalizing imports and reducing tariff and non-tariff barriers, buyers and sellers are able to access least-cost goods and services available in world markets. Local entrepreneurs, especially those who are managing small and medium enterprises, are able to source least-cost components, spare parts and technologies from abroad.

To highlight the gains from opening the country to foreign trade, the microeconomic inefficiencies and macroeconomic instability spawned by a protective foreign trade policy regime will first be discussed below before the actual policy adjustments that have been put in place.

Import-Substituting Policies. The foreign-trade policy regime based on high tariffs and quantitative import restrictions began after World War II when the government pursued economic self-reliance based on domestic production of some imported consumer goods and basic products traditionally considered industrial such as iron and steel and chemicals. Invoking infant-industry arguments, domestic producers obtained protection from imports through high tariffs and outright bans.

Domestic industries received special fiscal incentives and credit subsidies. The forgone revenue caused chronic budgetary deficits for the national government. Meanwhile, easy credit to the protected industries led to the excessive growth of money supply. The exchange-rate system in place was fixed. Inflationary fiscal and monetary policy under a fixed exchange rate produced large trade and current-account deficits that could not be sustained, resulting in balance-of-payments (BOP) crises.

The sector heavily penalized by the protective trade policies was agriculture. Many of the products covered by high tariffs and import bans were agricultural inputs such as fertilizer, seeds and farm machineries. The fixed exchange-rate system generally yielded an overvalued peso, penalizing exports, much of which came from agriculture. The sector remained traditional, resulting in a high incidence of rural poverty and rapid rural-urban migration.

Meanwhile, none of the domestic industries accorded protection achieved world-class standing. Without competition from imports, the local firms had no incentive to cut production costs and innovate. They were content to sell solely in the domestic market, which was profitable for them for as long as the trade protection remained.

Consumers paid higher prices than they had to. Savings was adversely affected, setting the stage for the foreign-debt crisis. An added social cost from the protective trade regime came from the smuggling it engendered. The customs duties that the government would have captured were diverted instead to corrupt private pockets, putting social cohesion in grave danger. The desired industrial transformation failed to materialize under import substitution. BOP crises occurred periodically. Poverty incidence stayed high.

In the meantime, other developing countries in Asia that resorted to outward-oriented industrialization, namely, Taiwan, Hongkong, Singapore and South Korea, emerged as exporters of manufactured products on a global scale. Dubbed today as newly industrializing countries, they have been held up correctly as models of successful industrialization.

Import Liberalization and Tariff Reforms.[1] The country's shift toward liberalized foreign trade with import liberalization and tariff reduction as the centerpiece policy reforms has been taking place for over a decade now. A succession of governments beginning with the Marcos administration has shown varying degrees of commitment to these trade policy reforms. President Ferdinand E. Marcos flip-flopped on these reforms amid lobbying by interest groups.

The main strategy calls for the removal of quantitative import restrictions, to be replaced by tariffs. Moreover, the tariff structure is envisioned to decline on the average, its dispersion to narrow down over time until it reaches a uniform rate.

The 1981-1985 tariff reform program involved narrowing the tariff structure from a range of 0-100 percent to 10-50 percent. Some 1,403 tariff lines were covered by the phase adjustment. The important achievement of this program was to reduce the average nominal tariff rate from 43 percent in 1981 to 28 percent in 1985. The removal of quantitative import restrictions and licensing requirements also started in 1981. Between 1981 and 1984, a total of 860 items was liberalized. Another 74 items were liberalized in 1985. Some of the broad product lines included in that import liberalization measure were meat and meat preparations, dairy products, pharmaceuticals, oils and perfumes, rubber and cork, textile yarn and fabrics. This sampling is intended to give the reader an idea of the extent and scope of the restrictive trade regime prevailing before 1981 and the opportunities for rent seeking which that regime opened up.

In 1986, the Aquino administration took over and resumed the trade liberalization program that was stalled by serious political disturbances. The tariff program in 1986 started the shift to a uniform tariff rate. A minimum tariff rate of 10 percent was set under Executive Order (EO) No. 70. The tariff rate on crude oil was reduced from 20 percent to 10 percent in 1987 under EO 306. Tariffs on several other basic industrial products like iron and steel, paper, polyester and glass were also reduced.

The lifting of quantitative import restrictions was accelerated in 1986 with the liberalization of 994 items, including tires, iron and steel, paper, rubber and footwear, among others. In 1987, three lists with phased lifting of import restrictions and licensing requirements were drawn up. List A had 104 items to be liberalized not later than 1989. List B consisted of 455 items to be liberalized after studying the feasibility of the existing import restrictions. List C with 114 items maintained the restrictions for reasons of health, safety and national security.

It is useful to highlight EO 470 which was issued in 1991. For the period 1991-95, the tariff guidelines set a minimum tariff rate of three percent and a maximum of 30 percent. Capital equipment tariffs were set at 10 percent if there is local production and 20 percent if there is none. Exemptions from these rates were permitted as meritorious cases. In addition, an increase of up to 100 percent of existing tariff rates on items subject to quantitative restrictions was permitted upon liberalization.

The liberalization process was accompanied by a strengthening of safeguard measures against unfair trade practices. For example, the Societe Generale de Surveillance was contracted to implement a comprehensive import surveillance system. The anti-dumping law was strengthened while penalties for smuggled goods were made stiffer.

The Ramos administration accelerated the import liberalization and tariff reduction program. In July 1995, EO 264, EO 470's successor was issued, covering chapters 25 to 97, the non-agricultural items of the Tariff and Customs Code. Over the period 1995-2000, the four-tiered tariff structure of EO 470 will be phased down so that the rates on 85 percent of all tariff lines shall be only three percent for raw materials and 10 percent for processed and finished goods by the year 2000. EO 264 also provides that by the year 2003, the remaining 15 percent shall likewise have been phased down to three and 10 percent. By the year 2004, a five percent uniform tariff rate will be in place.

For agricultural products, EO 288 was issued in 1996 for non-sensitive cases or products not subject to quantitative import restrictions. In line with the commitments of the government with the WTO, the legislative measures lifting import restrictions on sensitive agricultural products and their replacement by tariffs are well underway.

The challenge posed by the liberalization of trade in agricultural commodities centers on how to modernize agriculture so that it can compete with imports. The government has drawn up a master plan for this. It includes stepping up investments in rural infrastructure such as irrigation, farm-to-market roads, and post-harvest facilities. Support for agricultural research is also being increased to modernize seed and other agricultural inputs. Human resource development is of course integral to raising agricultural productivity.

Another challenge is gauging the tariff rate to be applied upon the lifting of import restrictions. If the rates are set too high so that even inefficient agricultural producers are rewarded for maintaining their high production costs, then society suffers from a waste of resources that can be released to more valued uses in other sectors of the economy.

Meanwhile, the coordination of government responses to other challenges emerging from a liberalized foreign trade rests on the Committee on Tariff and Related Matters, another inter-agency committee alert to the required adjustments to prevent import surges and unfair trade practices. But to facilitate timely and strategic responses, the President's power to set tariffs must be maintained.

Investment Policies. Along with the liberalization of the trade account, the government has made great strides in liberalizing direct foreign investments and other elements of the capital account like trade in securities and other debt instruments. In line with the complete-market perspective for raising welfare, the liberalization of the capital account addresses the limitations previously observed in the capital and financial markets.

In 1991, the Foreign Investments Act (FIA) was enacted. It allows foreign equity in Filipino enterprises to exceed 40 percent provided the firm seeks no investment incentives and it does not engage in an activity which appears in Negative Lists A, B, and C of the FIA.

In the banking sector, Republic Act (RA) No. 7721 authorizes foreign banks to operate in the Philippines under various modes of entry such as by acquiring, purchasing, or owning up to 60 percent of the voting stock of an existing bank; and by establishing branches with full banking authority. With banking liberalization, one major challenge is the strengthening of the regulatory and deposit insurance mechanisms. Amid heightened competition, sound banking should be nurtured to enable the banking system to effectively carry out its task to mobilize domestic savings and mediate between savers and investors. The coordinative mechanisms for regulation and deposit insurance need to address, for one, any existing incompatible incentive structure such as the regulator's desire to see to it that banks continue to operate even if they have exceeded risk limits for sound banking and the insurer's incentive to close such banks to avoid making huge insurance payments later on.

The ordeal of conducting economic and business affairs in an uncertain world is widely recognized. Savers, for example, seek financial instruments that diversify risk. Bank deposits are illustrative, with the Philippine Deposit Insurance Company guaranteeing limited payments in case a bank experiences a run and fails. Likewise, stocks perform risk-bearing functions. They are tradeable financial instruments representing ownership of capital in an enterprise. But their prices fluctuate and so opportunities for profits and losses coexist in the stock market.

The two bourses have been unified but the remaining tasks are not easy. One, the regulatory framework supervised by the Securities and Exchange Commission (SEC) is being strengthened to prevent anomalies like insider trading. Two, efforts are being exerted to broaden and deepen the stock market.

Exchange-Rate Policy.[2] The exchange-rate system consistent with the liberalization of trade and the capital account is a flexible one. In this connection, the BSP has put in place a market-determined exchange-rate system to ensure full convertibility of the peso. The liberalization of capital and foreign exchange markets permits opportunities for trade in securities and national monies.

In 1971 when the world's major currencies went on a generalized float, the CB adopted a system of controlled floating. It intervened (in the spot and forward foreign-exchange markets) to keep the peso-dollar rate within a narrow predetermined band. Moreover, the foreign trade setting was quite protectionist in nature, marked by a great deal of restrictions on imports, exports and foreign-exchange trading. In this environment, the exchange-rate system was closer to a fixed than to a flexible regime.

Since 1991, however, several structural policy reforms supportive of a market-determined exchange rate have been undertaken. The CB relaxed the few remaining regulations on foreign-exchange trading: it allowed exporters, for example, to retain their foreign-exchange earnings in full; banks were permitted to create loan assets against their foreign currency deposit liabilities. Meanwhile, import liberalization was accelerated and ceilings on foreign equity investments were relaxed.

In a liberalized foreign-exchange market, the fundamental factors affecting exchange rate movements are real and monetary. In the short-run, monetary factors matter greatly for the exchange rate. If the Philippines lets its money supply grow faster than that of, say, the US, then the peso depreciates in relation to the dollar. Put another way, if the country's monetary policy leads to a higher inflation rate here than in the US, then a peso depreciation will ensue. Actions not only of the BSP but also of the US Federal Reserve Board affect the peso-dollar rate. If the latter raises interest rates to tighten money, the peso will depreciate in the short run.

As for the real factors, one important variable influencing the exchange rate is output growth. If real gross national product (GNP) in the Philippines grows faster than that of the US, then the peso may appreciate. The higher output growth is translated to monetary terms through an increase in the demand for money.

How then does one conduct monetary policy under a flexible exchange-rate system? A fixed money-growth rate consistent with the demand for real cash balances minimizes fluctuations in the peso-dollar rate arising from unanticipated money growth. But external factors, like actions of foreign central banks, can still cause the exchange rate to fluctuate.

The challenge to the BSP, as earlier mentioned, is predicting shifts in money demand which are quite pronounced in an open economy with capital mobility and flexible exchange rates. There are several indicators of whether the change in money demand is permanent or temporary, including nominal interest and exchange rates and the level of foreign reserve assets. Leading indicators of inflationary expectation can be obtained by looking at the interrelationships among nominal interest and exchange rates. Inflationary expectations are self-fulfilling since security and money traders incorporate them immediately in the yields for debt instruments of varying maturities and in the spot exchange rate. To establish its credibility as an inflation fighter, the BSP must be prepared to launch preemptive strikes against such expectations. In this case, more information is better than less. This in turn is a situation more likely in a liberalized than in a repressed financial setting. In this regard, it is important to have all the financial, capital and foreign-exchange markets liberalized.

IV. PLANNING AND REGULATION OF MARKETS

The adoption of market-oriented policy reforms naturally raises the question of how development planning by government should be conducted. Using the competitive-market framework discussed in Section II above, some market failures calling for collective action have been identified. This is seen, for instance, in the case of public goods where the inability to exclude non-buyers preclude pricing. The value that individuals attach to public goods cannot be ascertained at some reasonable cost and the government intervenes by providing the service through a tax and expenditure scheme.

In this context, the government plans and it does so for many reasons. The important ones are: (1) to ensure that scarce taxpayers' money goes to socially efficient projects; and (2) to provide a stable and predictable environment for the private sector.

To realize the first objective, the first thing that planners in government ask is whether or not the government has a legitimate role in the activity at hand. Usually, if private markets are seen as underproviding the service, then the government may step in. This is witnessed, for example, in basic education and health. This is not to say, however, that social institutions other than the government are not qualified to undertake the needed correction. As for the second objective, the role of government in the conduct of fiscal and monetary policy has been discussed at length in previous sections.

An institutional constraint to planning introduced recently stems from the Local Government Code which has devolved to local government units (LGUs) several activities previously undertaken by the national government in sectors like health, social work, agricultural extension and public works. With the devolution, LGUs get an entitlement equivalent to 40 percent of total internal revenue. One challenge to government development planning is the coordination of national and LGU plans so that wasteful duplication of programs and projects is avoided.

Government planners also need to look at the regulatory rules that must be applied in a market-oriented economy. Regulation is indicated in areas where imperfect competition exists. When there are increasing returns to scale, for example, competitive pricing is fatal to the enterprise. Rules on entry and exit must be clarified and refined so that cut-throat competition is avoided and quality service at reasonable prices is assured.

Another formidable challenge is steering the economy to a growth path that is both efficient and equitable. In many cases, there are trade-offs between efficiency and equity. In education, for instance, it is more efficient to concentrate resources on the more-able pupils since it costs less to equip them with a given level of schooling. But this raises questions of fairness. The challenge to planners is designing policies and programs that strike an acceptable

balance between efficiency and equity. This task properly belongs to the Investment Coordination Committee of the NEDA Board. This committee is capable of evaluating the social desirability of projects in case private markets are unable to do so for one reason or another.

Given the greater openness of the economy, made possible by the trade and industrial policy reforms of recent years, the emerging institutional challenge is how to be competitive amid rising real wages. As the economy moves toward full employment, real wages rise. This poses no problem if total factor productivity (TFP) also goes up. The answer lies in a continuous rise in TFP, or the efficiency in use of labor of different skill types and capital of varying vintage. The sources of TFP are many. The important ones come from investments in education, training and research. To improve the allocation of resources to these activities, policy reforms are needed in government support for research and development. Meanwhile, the current structural policy reforms which liberalize foreign direct investments help raise TFP through the technological progress embodied in modern physical capital like computers. Lastly, the realization of economies of scale, another important dimension of TFP, hinges on how well the government is able to bring in the second-generation policy reforms, for example, those involving the design of appropriate regulatory policies when imperfect competition is indicated. Telecommunications, airlines and organization are vital issues. Relatedly, a law-and-economics agenda is indicated.

Political-Economy Type Challenges. Since the government will continue to provide public goods under the structural policy reform program and to regulate under imperfect competition, interest-group competition is bound to emerge. In principle, the provision of public goods is done through voting. However, since legislators generally have their own preferences, the allocation of public goods may not be fully consistent with voters' wishes. Legislation is the outcome of interest-group competition. The well-organized and adequately funded groups are likely to secure favorable legislation. A principal-agent problem is indicated and the challenge is to design mechanisms that make legislators, the agents, act in the interest of the voters, the principals.

Meanwhile, the government can promote or impede certain industries through regulation. If a particular interest group succeeds in getting a favorable regulatory measure, losing groups may challenge the decision in the Judiciary. Once a constitutionality issue is raised, the Supreme Court adjudicates. But after the highest court has decided, future policies are affected since the decision can be invoked as precedent-setting. In this regard, the importance of having a law-and-economics agenda is worth reiterating.

What all these suggest is the need for a constant review of the government's role in the economy. The government does not have the sole mandate in the delivery of collective actions. There are substitutes such as those based on cultural norms and unwritten rules of conduct, including philanthropy, voluntarism and cause-orientedness, all of which lie at the core of Filipino values.

V. CONCLUDING REMARKS

Much progress has been achieved under the policy reform program of the government. In terms of macroeconomic performance, output growth with single-digit inflation has prevailed since the recovery from the stagnation of 1991, and the prospects for sustainability are bright particularly in view of the remarkable achievements in narrowing the budget and the current-account deficits. Meanwhile, labor productivity is improving, a development that lays the foundation for long-term industrial restructuring and broad-based growth.

Having gone this far with the reform program, which is by no means complete at this point, it is ill-advised to backtrack on it. Private enterprise and competition motivate efficiency improvements and innovation and should form part of the country's cultural capital, to be transmitted from generation to generation. This is a big challenge particularly for academics in search of a research agenda in these changing times.

It is clear that there are still some individuals, planners and legislators—though their tribe has decreased—who believe that the government must intervene heavily in the market to correct occasional market inefficiencies. Such thinking can be traced to the country's colonial past, when strong central control over the periphery was the dominant thought, both in economic and political terms. The colonizers introduced the notion at a time when it was already discredited in its country of origin. Chipping away at that idea took centuries; it should not be permitted to take hold again.

NOTES

[1]This section draws heavily from D. B. Canlas, E. Avendano, and T. Lopez, "Tariff Reforms in the Philippines," unpublished (Pasig: NEDA, 1995); and from D. B. Canlas, V. Enriquez, A. Peralta, A. Cebuma, and B. Mendoza, "Trade and Investment Policies and Growth Centers in the Philippines," unpublished (Pasig: NEDA, 1995).

[2]This section uses materials from D. B. Canlas, "The Philippine Peso Under a Flexible Exchange Rate," Working Paper, U.P. School of Economics, Diliman, Quezon City, 1994.

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COMMENTS

*Merlin M. Magallona**

The paper of Dr. Dante B. Canlas seems to encapsulize the developments that are relevant to this conference, particularly the ascendancy of capitalism with the collapse of socialist economies. Let me therefore make a brief survey of the salient aspects of the so-called emerging world economic order which bear directly on what is happening in terms of trade and investments in the Philippines.

For the first time in the postwar era, the three centers of world capitalism are simultaneously in the depths of a recession. Contrary to the claims of Western and Japanese leaders, the European Community, the United States, and Japan whose economies account for 70 percent of the world's production are laying off workers by the tens of thousands. The International Labor Organization has declared that unemployment has become a global crisis with almost 30 percent of the world's labor force or 820 million people unemployed. Multinationals are downsizing even as their manufacturing plants are migrating to low-cost countries. The point to be made here is that the Philippines stands to gain from the migration of capital to low-cost countries as a result of the ongoing deindustrialization or the hollowing out of manufacturing industries in the traditional industrial centers.

Another point I wish to make is that it is essential that we begin to identify the objective content and direction of the Emerging World Economic Order and the Philippine's place in it. The impact of the restructuring of the world economy certainly will not be limited to economic consequences alone. There is a need to outline some of the fundamental adjustments we are called upon to make, at least in terms of legislation. Some of these adjustments are: (1) the revision of the General Banking Act to accommodate the entry of foreign banks (initially, 10 banks); (2) the enactment of a law authorizing a 75-year lease of industrial lands by foreign investors, the constitutionality of which is still an issue; (3) a new mining law allowing 100 percent foreign-owned companies to explore and develop mining resources in the country; (4) an amendment to the Condominium Law allowing foreigners to own condominium units; (5) a new policy for the entrance of foreign insurance companies; and (6) a pending law doing away with the Retail Trade Nationalization Act to pave the entry of retail and superstores from South Korea, Hong Kong and Japan.

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Above all, we have the introduction of the national treatment principle in the Uruguay Round agreements which will erase the distinction between Filipinos and foreign nationals in the exercise of economic rights and investment opportunities. The question that should be posed is: Where shall we draw the dividing line between liberalization and Filipinization safeguards? How do we now, in the context of globalization, redefine our national interest?

Policy-making in the Philippines consists of two levels. The highest level determines the main direction of the national economy, in particular, the strategic and long-term course of economic development. The second level concerns itself with approaches to implement these strategies and directions. The democratic and republican character of our institutions should find expression in the highest level of our political hierarchy. Yet it is at the highest level of decision-making that the overwhelming authority of transnational capital operating through the International Monetary Fund (IMF) and the World Bank holds sway. Our policy-makers have been relegated to performing second-level policy implementing functions at various times.

A large part of Dr. Canlas's paper discusses trade liberalization and market reform. The Philippine economy is one of the most liberalized in Asia. According to *The Financial Times* (October 2, 1995) reporting on the Philippines, "almost all of the textbook moves recommended by the International Monetary Fund are in place." Yet foreign capital demands that the economy be liberalized further. I think that it is a challenge for us to carefully examine the globalization process, particularly the shift in bargaining power and leverage among countries in regard to the flow of investments and capital. For example, a study of Japanese investments would show that the Japanese economy is borderless, expanding to Southeast Asia in search of locations for its industries. Here we have a situation that if Japan cannot relocate its industry abroad, its home-based industry will not survive competition. This should give us pause to reconsider our investment policies. I think that Japanese investors may need us more than we need them. This is a challenge, therefore, for us to rethink our policies.

I realize that there are objective conditions underlying the makeover of the global economic order which perhaps we are powerless to change. But I would like to believe that our interpretation of global realities should translate into opportunities which we can exploit for our own economic and national interest. Let me end with a quote from Robert Reich's *The Work of Nations*: "We are living through a transformation that will arrange the politics and economies of the coming century. There will be no national products, no national boundaries. There will no longer be national economies at least as we have come to understand the concept. All that will remain within national borders are the people who comprise nations." I wonder what would be left of the Philippines if we do not address all of these in terms of the national interest.

COMMENTS

*Felipe M. Medalla**

I disagree with a lot of things that Dean Magallona is saying about the world economy. For instance, our bargaining level with respect to Japanese relocation is probably close to zero because Japan also has Indonesia, Vietnam, and Thailand to choose from. It is really hard to tell Japan how to invest and what products to buy or make in the Philippines. But that is another story.

I'm reading Dr. Canlas's paper as one written by somebody who works in government, who knows what's going on, but cannot say everything he wants to say. I will say what I think he wants to say.

Firms are going global. The global firm is now the unit of analysis, not the country. In that setting you can either become more closed like Myanmar, or you can open up and ride the tiger, so to speak. Now, the difficulty with riding the tiger is what we all know as the theory of the second best. If you have 1,000 markets 200 of which are closed or not working, you do not necessarily make things better by having 900 markets working, or reducing the number of failing markets by half. This happens when errors cancel out errors; when the number of errors is reduced the total effects of the errors increase. Is the Philippines ready for the theory of the second best? How do we develop institutions to increase the benefits from economic reform? Export industries, for instance, are adversely affected when we open up capital markets but maintain quantitative restrictions on food imports.

Dr. Canlas correctly points out that there is room for government intervention when you have market failure because of information problems or monopoly problems. How does government make things better? My answer is rules rather than discretion. When people see that the intervention is transparent, neutral and fair, so will the market. There are two types of rules: the formal rules enforced by the formal systems, including the police and the courts; and the informal rules which people voluntarily follow because they find it in their interest and in accord with their values to do so. Why do people line up for jeepneys? They see that the system works and they see

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that it is followed. In contrast, traffic gets worse when people flout traffic rules because they know that the system is not working and those who break the rules are rewarded.

The problem with market intervention is that market prices have two functions. One function is to allocate resources: scarce things become more expensive, more will be produced, less will be consumed. On the other hand, when you have surplus, prices go down, more will be used, less will be produced. Fine. But prices also play a redistributive role: everyone wants to sell high and buy low. You want what you buy to be cheap and what you sell to be expensive. The problem is, it is not possible to apply this consistently to everybody. When the ability of government to address redistribution issues is limited—that is, when government cannot tax progressively because the tax administrators are corrupt, or when government cannot redistribute land because the landlords are very powerful—market-enhancing intervention is likely to be bureaucratically or politically infeasible. Therefore, intervention takes place where it is not wise to interfere to begin with. In other words, when intervention in the area of income and wealth redistribution is not possible, there is great pressure to intervene with prices or in areas where markets work. It is a tragedy that there is very little we can do in areas where markets don't work. It's a bigger tragedy when the market works but we will not allow it to work because we do not like the consequences of price changes. What better examples than oil and rice?

The other thing that I want to disagree with is Dr. Canlas's idea of coordination between the national government and local governments in the provision of public goods. In theory NEDA planning will result in greater consistency. Unfortunately, this is not the way it looks from below. Local governments want less national coordination and more local entitlements. Tip O'neill's advice is appropriate here: All politics is local. Given the politics of the budget process, it could very well be that block grants to local government units are on the whole superior to "nationally coordinated" local public expenditures.

In summary, the balance between equity and efficiency is very hard to achieve. I think the question we have to ask ourselves is this: Given how difficult it is to balance these two goals; given that

the bureaucracy and the power elites have reduced all but a few areas where the government can operate for the benefit of the people, do we have the luxury of letting markets work?

3. Regionalism vs. Multilateralism (A Panel Discussion)

Temario C. Rivera
Emmanuel C. Lallana
Alfredo C. Robles, Jr.

Temario C. Rivera:

I want to focus on two major problems that I consider important in understanding some of the problems of governance in the context of the emergence of a multilateral organization in the region, particularly the Asia Pacific Economic Cooperation (APEC).

First, I would like to focus on two contrasting styles of capitalism. In most mainstream discussions in the economic and political science literature, it is assumed that there is a uniform trajectory of capitalist development. The World Bank, for instance, has identified this in the success of the East Asian tiger economies. If we take a closer look, however, we can in fact speak of two contrasting styles of economic growth and development. The first we can associate with the more classic Western style of development and the second with a more peculiar Asian type of capitalism.

Though very basic, this distinction is relevant to a discussion of multilateralism because many of the problems within APEC are reflections of these two contrasting styles. In the case of the newly-industrializing countries of East Asia, for instance, there is statist intervention in that states have actively participated in providing the strategic direction of the economic growth in these countries. In the literature, there is an extensive discussion of the same phenomenon in the newly-industrializing countries (NICs) of Southeast Asia. There is a need, therefore, to understand what in the institutional environment of the newly-industrializing economies (NIEs) in East Asia and in Southeast Asia has made them succeed in a kind of development which has been criticized in the West.

In the Philippine context, this is very relevant because there is now an emerging consensus about the appropriateness of a minimalist state. This is a crucial problem because there is an alternative here. In other words, we pose the question: Are we

ready for global competitiveness? An important consideration here is what globalization has to do with the kinds of institutions and organizations that we have in place. What would be the relationship, for instance, between the state and the civil society? This question is particularly relevant to the Philippines where we have a tradition of a weak state and a robust but intractable civil society with very powerful players like the landed cliques, the highly protected business sectors, the Church, the NGO community.

The second point has to do with the different strategic goals of the key players in the APEC. Much of the tension and conflict within APEC right now has to do with the fact that the key players do not speak with one mind. The developed western industrialized countries led by the United States and Australia favor the institutionalization of a free trade regime with predictable rules and a definite schedule of commitments to put these agreements in place. In contrast, Japan and other countries such as China, Malaysia and South Korea argue for retaining a maximum degree of national flexibility in determining trading arrangements. Even within the ASEAN, there is no consensus with Singapore and Malaysia articulating contrasting positions.

Moreover, many of the leaders of the developing economies in APEC express apprehension that the weaker economies cannot compete with the powerful economies such as the United States with its vast technological superiority in many fields. Moreover, they point out that the United States has the habit of unilaterally acting as the world's economic police officer with its practice of imposing conditionalities on trade such as human and worker rights and environmental concerns which work to the immediate disadvantage of the weaker economies.

To cite Japan as a specific case, its original idea of an APEC-type formation was not really a free trade area but rather a Pacific version of the Organization for Economic Cooperation and Development (OECD) which is basically a forum for consultation and technical cooperation in economic matters. In slowing down the institutionalization of APEC as a free trade area, Japan is essentially protecting what is now a *de facto* integrated regional bloc under its leadership. I am referring here to a regional development marked by Japan's establishment of trading and investments in the region since

the Plaza Accord in 1985. On the other hand, the United States (US) is trying to reverse the process of Japan-led integration in East Asia. It is trying to create more space for its corporations to successfully compete against the state-assisted conglomerates of Japan and the NIEs.

To appreciate this conflict let us now take a quick look at the essence of the agreement that emerged in Osaka. The liberalization blueprint included a set of general principles and recommended policy measures whose precise interpretation continue to be contested. On the one hand, you have countries such as the US, Australia, Canada and Singapore articulating the view that trade liberalization should be comprehensive, affecting all sectors including agriculture. On the other hand, you have countries such as Japan and China arguing that each country should be allowed maximum flexibility in interpreting these rules.

Unlike the experience of the European Union, it is unlikely that liberalization norms for the APEC members will come about through legally binding commitments by all members. It will most likely be fuelled by a continuing process of consultations and flexible negotiations through individual action plans by member states. It is true that the market forces at work in the Asia-Pacific region have facilitated the economic linkages that now make possible a project such as APEC. At the same time, however, the rapidity and extensiveness of these economic ties accelerated by the pervasive Japanese presence have not erased the continuing bases of political and security tensions that underpin historic relations in the region.

This problem needs to be studied and articulated further. It may be useful to analyze to what extent the existing sub-regional arrangements, i.e., ASEAN and its ASEAN Free Trade Area (AFTA), are compatible with APEC. From the point of view of a country like the Philippines and from the regional point of view of ASEAN, there is some room for continuing negotiations in the meantime that APEC still lacks a strategic unity of vision among its members. To that extent, it also offers openings for initiatives by individual countries and the ASEAN as a whole to come up with a unified plan that would be to the benefit of a small country like the Philippines.

Emmanuel C. Lallana:

I wish to focus my comments on the future of multilateralism in the Asia Pacific. The history of multilateralism in the region is a very recent one. Very few countries in the region have extensive experiences with multilateralism. An important development is that there are now two emergent multilateral institutions in the region: the Asia Pacific Economic Cooperation (APEC) and the ASEAN Regional Forum (ARF).

As we all know, APEC was organized in 1989, had its first summit in 1993, and is committed to free trade by 2010-20. Notably, APEC is a voluntary, consensus-based process. With APEC, the Bogur Statement and Osaka Declaration, though not legally binding, are public declarations of strong commitments. There are three important problems that need to be tackled in trying to understand the future of APEC. One is the big debate over whether APEC should be rule-based in much the same way that the European Union (EU) is, or whether it should stick to its unique Asian characteristics which privilege process over organization.

The second issue confronting APEC is the question of leadership. Posing the same issue in academic terms: Will APEC need hegemonic leadership or small group leadership in order to flourish? The choice of hegemonic leadership is usually and not surprisingly made by the Americans. But a number of APEC members choose small group leadership, some sort of troika involving the United States (US), China and Japan. The latter, though politically acceptable, may be more difficult to achieve. The literature on the small group or key group as a substitute for the leader underlines the difficulty of arriving at agreements within the group. Several theoretical solutions to this problem exist but no single solution currently commands general acceptance . Small or key groups also confront enforcement problems that are difficult to overcome.

There are other problems associated with the possible US-China-Japan troika. One of these is rooted in the historic and current relationship between potential partners in the troika. In her study of allies, adversaries and free trade, Joann Gowa (1994) concludes that the real income gains that can motivate free trade are the source

of the externalities that can either impede or facilitate it. Trade with an adversary produces insecurity in the economy while trade with an ally produces a positive externality. Given this trend, is it to America's interest to strengthen the military capacity of China by increasing trade through APEC?

Perhaps the most contentious issue that faces APEC is the broadening of its agenda to include security issues. As early as 1993, important voices in the US had been calling for the expansion of APEC's economic mandate. Before the APEC Seattle Summit, US Senator Richard Lugar suggested that it was time to examine APEC's potential for managing economic and non-economic issues, including security concerns in the entire region. This raises a number of problems. In the first instance, the question that must be asked is: Are security and economic issues unified, or is it possible to have separate fora for the discussion of these issues? Second, assuming that security and economic issues are unified, what will happen to the other multilateral initiatives in the region which deal specifically with security concerns, notably the ARF?

The ARF is an ASEAN-led effort to create a security regime in the Asia Pacific. It took ASEAN more than 25 years to openly hold discussions on security issues. Previously, security concerns were subsumed under political cooperation issues. The role of the ASEAN in the creation of the ARF ensures that there will be more of a process orientation rather than a rule-based orientation. The ARF confronts problems similar to those confronted by APEC: institutionalization and leadership. As in APEC, institutionalization divides the ARF between the ASEAN and non-ASEAN states. Non-ASEAN countries like Australia are for the greater and faster institutionalization of the ARF. On the other hand, ASEAN countries like Malaysia are for a slower process. The leadership issue, meanwhile, has a different cast in the ARF. ASEAN has kept the leadership in jealous guardianship. Now it is not only ASEAN tenacity that makes it possible for the sub-regional organization to stay at the driver's seat. It is not even intellectual leadership because the Australians and the Canadians are far more creative in their proposals and they are willing to back up their ideas with funds. ASEAN leadership in the ARF is made possible by the seeming disorientation of the US in the

post-World War Asia Pacific. The other important reason is China's willingness to accept ASEAN leadership and its unwillingness to accept American or Japanese leadership in the ARF.

Some sectors are calling for a merger between the APEC and the ARF. I argue that the two are distinct processes and there is no easy way of unifying them. The difficulty begins with the very concept of the Asia Pacific itself, the object of economic and political cooperation. There is the view that the Asia Pacific is a contested concept. In short, the definition of what constitutes the region is not settled and remains one of the major political questions in the region in the closing decade of the 20th century.

While an ocean does not make a region, I am not as skeptical as the view that there is no Asia Pacific. But there are different Asia Pacifics. The economic Asia Pacific is different from the security Asia Pacific. Using the economic yardstick, the Asia Pacific has defined itself as the set of East Asian and Pacific countries joined by intense trade and investment ties. On the other hand, actual patterns of amity and enmity among states determine the actual membership of the Asia Pacific security region. From this perspective, it is not an accident that APEC and ARF have different members. Furthermore, it would be unlikely that they will have similar members. For instance, it may make sense for Chile to be in APEC but it is clear that Chile would bring hardly anything to the search for security in the Asia Pacific if it joins the ARF.

The issue of membership will also complicate the possibility of convergence. APEC members are economies; ARF members are states. This allows Taiwan and Hongkong to be members of APEC but not of ARF unless a miracle happens in China or that reunification happens soon. Beijing will never allow these two economies to become ARF members. So in fact security and economic issues cannot really be divided or taken in isolation. But neither can they be easily joined. This is the problem that confronts us in our attempts to chart the future of multilateral institutions in the Asia Pacific.

Alfredo C. Robles, Jr.:

I would like to argue that one common feature of multilateralism is an absence or, if you wish, a negative presence which I will call the democratic deficit. I will attempt to convince you that democratic deficit is a problem which multilateralism needs to address. Then I will examine possible solutions to this problem.

The democratic deficit is a problem typically associated with international organizations. First raised in the context of the European Union (EU), democratic deficit refers to the feeling that decisions are being made by anonymous forces, whether bureaucrats or capitalists, behind the backs of the electorate who have no say at all in such important decisions as the single European market or mobility of capital or other factors of production. Although the problem has not been explicitly posed in other multilateral contexts, one can argue that it applies to other international organizations for the simple reason that only states are represented in international organizations. The only notable exception is the International Labor Organization which has a tripartite structure.

The consequence of democratic deficit in multilateral settings is a loss of legitimacy which can imperil any of the arrangements arising from this context. Again, let me refer to the European context where we have some very concrete manifestations of the risks. A widespread unease or malaise, though not necessarily expressed in terms of democratic deficit, resulted in a negative vote for the Maastricht Treaty in Denmark, and a very low majority in France and other European countries. More broadly, one can argue that the strike in France in November and December as well the as surprising vote for Pat Buchanan in the United States were expressions of malaise arising from the globalizing trend concretized in multilateral arrangements. More and more voters are fearful of the future. They resist globalization because decisions seem to be remote and unresponsive to their needs. To quote an American political scientist: "Vital interpenetration runs far ahead of the establishment of new governing institutions capable of providing democratic control over processes of globalization."

It will simply not do to tell people they are mistaken or incapable of preserving their interests. They must be able to feel that they have not only a stake but also participation in the way decisions are being made. Political scientists have to admit that there is very little accountability in foreign policy decision-making. The only democratic control, if one may call it that, in multilateral arrangements is ratification which is limited to legislatures. Very few states hold referenda to ratify very important treaties. In this respect of course the European example is the exception which confirms the rule. Everytime there is an enlargement, everytime there is a new treaty, most European states hold different referenda. The British did not hold a referendum over the Maastricht Treaty for fear that it might not be approved.

What are the possible solutions to a democratic deficit in a multilateral context? There can be typical interstate solutions or a broader approach to include representatives of national and international civil society.

The first type of solution is based on the predominance of the state as the subject of international law. This is more in keeping with the current structure of the international community where the states are the primary subjects of the laws which they make for themselves. A related solution is broadening the application of the one state-one vote formula to include the most important multilateral institutions, namely, the World Bank and the International Monetary Fund (IMF). Although still a state-centric solution, this would nonetheless represent a significant improvement on the one dollar-one vote formula now dominant in the most important multilateral economic institutions. The drawback of course is that there is no guarantee that the state is actually casting the vote that is truly representative of civil society.

Another solution of the first type, which is advanced by the independent Commission of Advanced Study of the United Nations, is to strengthen the Economic and Social Council (ECOSOC) of the United Nations. This is at present a consultative body promoting studies and conferences, and it is not really very powerful. It has been proposed that the ECOSOC be given powers of coordination and planning. This proposal is directed primarily at the Bretton

Woods institutions which, although specialized agencies of the United Nations, nonetheless enjoy a large degree of autonomy. The objection is that the ECOSOC might fall under the sway of the IMF and the World Bank.

A third solution to the problem of a democratic deficit in multilateral arrangements is at the limit of the interstate and non-state-centric solution to the problem: The establishment of multilateral economic institutions and institutions comparable to the European parliament, an assembly based on direct election by European voters. The members of the European parliament organize themselves not along national lines but along party lines. Of course, one could argue that participation rates in elections for the European parliament has been very low. Moreover, the parliament itself is not very influential in decision-making in the EU. But if the parliament were given more powers, then perhaps there would be better participation in European elections.

The second set of solutions to the democratic deficit in multilateral arrangements would be bolder and it would include attempts to promote the participation of authentic representatives of civil society. It is not enough to hold ASEAN Boy Scout Jamborees or Orchid Shows, or to have decorative inter-parliamentary organizations which do not have influence in decision-making. Allowing NGO representatives to participate as observers is already the case with ECOSOC. This already happens in the preparation of summits. But it would be one step forward to institutionalize this participation. Without giving them the right to vote, one could allow nongovernment organizations (NGOs) to make statements at meetings and to circulate their documents as a matter of course. A truly revolutionary step would be to create assemblies to represent international civil society in international organizations. One proposal by NGOs is the creation of a third chamber at the United Nations. Right now we have the General Assembly and the Security Council, both state-centric organizations. The UN Charter begins with the statement: "We, the people of the United Nations." It would be in keeping with this spirit of representation of nations to have a third chamber composed of representatives of peoples or different sectors. (In the case of the World Trade Organizations, why not an assembly of consumers? of producers?)

In conclusion, the proposed solutions to address the democratic deficit might seem Utopian to hardened realists. Nevertheless, this problem must be recognized and addressed. As international organizations and international agreements integrate more states, they touch the lives of more people and integrate more sectors. The problem of democratic deficit would thus become more acute. Democratization within states must be paralleled by democratization on the international level. Those who claim to apply democratization at the domestic level cannot afford to ignore the democratic deficit in the multilateral context. This is the true test of the commitment to democratic principles.

Part 2
SECTORAL IMPACT

4. Services and Development in an Open Economy: Nontradeable Services

Mario B. Lamberte

INTRODUCTION

The services sector received very little public attention in the past because economic policy makers and analysts had been conditioned by the theory that a country's economy progresses from an agricultural to an industrial one, and finally to one dominated by the services sector. Historical facts do not support this theory. Majority of the world's economies, including both developed and developing economies, are service economies in the sense that they rely more on the services sector than on other sectors for output and employment. Because of this, many have started to change their perspective on the role of the services sector in economic development.[1]

There is also a growing awareness of the close linkages between the services sector and other sectors of the economy. In the past, most developing countries exerted a lot of effort and resources in developing and modernizing their agricultural and industrial sectors, leaving their services sector virtually unattended. However, the underdevelopment of the services sector placed a severe constraint to the development of the the agricultural and industrial sectors. This has led to the recognition that the services sector provides not only services directly to consumers but also intermediate inputs into other economic activities. Accordingly, "sectors such as banking, shipping, transport and communications constitute the infrastructural core of the development process" (Puri *et al.*, 1989, p. 14). Clearly, a weak services sector contaminates other sectors of the economy. The complaint often heard from poultry and livestock producers that it is cheaper to ship corn from Thailand to Manila than from Mindanao to Manila is a classic example of a weakness of one service subsector, interisland shipping, which impedes the development of one economic sector.

Policy has a large role to play in the development or underdevelopment of the services sector. For instance, the cheap credit policy that strongly encouraged rural banks to lend to farmers caused an unnecessary wear and tear on the rural banking system, resulting in a weakening of the system as a whole (Lamberte and Lim, 1987).

It is now widely accepted that services can be internationally traded. Many countries have significantly large receipts from trade in services. Although trade in services is presently dominated by developed economies, the potential for developing economies to participate in this trade and to benefit from it is great, especially under the recently concluded General Agreement on Trade in Services (GATS).

All this suggests that the services sector has an important role to play even at the initial stages of the development process. The services sector can provide employment opportunities, satisfy basic wants such as education and health, and raise the productivity of other sectors of the economy. Because of this, a developing country like the Philippines should have a coherent policy framework consistent with industrial and agricultural policies as well as an effective national strategy for developing the services sector.

This paper analyzes the performance of the nontradeable services sector of the Philippines and identifies development and policy issues for the sector in the context of an open economy. The last decade has seen a substantial opening up of the Philippine economy. However, this mainly refers to the industrial sector. The services sector, on the other hand, remain closed. Thus, services provided by most of the subsectors within the services sector are still generally nontradeable, except tourism. With the recent liberalization of bank entry and the foreign exchange markets, financial services will soon become tradeable.

The next section discusses some conceptual and measurement issues relative to the services sector. This is followed by an analysis of the performance of the services sector as a whole and of the individual subsectors. Another section discusses some constraints and policy issues apropos the individual subsectors. The last section contains some policy recommendations.

I. CONCEPTUAL AND MEASUREMENT ISSUES

Services may be grouped into two major categories: (1) "consumer services," or those services that go directly to consumers; and (2) "producer services," or those that constitute intermediate inputs into other economic activities and are intended to support the production of goods and services. Some services may fall into these two types. For example, transportation service is consumed by commuters and at the same time is used to move goods from one place to another. Given this, it can be argued that there is no need to classify services. However, the purpose of making such categories is to emphasize the point that services have linkages with other sectors of the economy—a linkage not given due attention in the past.

Like other sectors of the economy, the services sector consists of categories that are quite diverse from each other. But while there is general agreement on what categories should belong to industry and agriculture, there seems to be difficulty identifying categories under the services sector. For instance, the World Bank includes utilities and construction in the industrial sector but several countries classify them under the services sector. Riddle (1989, p. 36) pointed out that:

> *the rationale for including utilities in the service sector rather than in the manufacturing sector is that in large part what is being purchased is the convenience of external provision, rather than self-provision, of the utility. For construction, the argument has been made that the majority of value added here lies in the engineering and design work (i.e., the professional service input) rather than in the actual bricks and mortar.*

In its national income accounts statistics the Philippines basically follows the World Bank definition of the services sector which includes the following major categories: (1) transportation, communication and storage; (2) wholesale and retail trade; (3) finance; (4) ownership of dwellings and real estate; (5) private services; and (6) government services. This paper follows this definition. (See Table 4A.1 in the *Appendix* for a more detailed typology of services.)

The conceptual problem is compounded once the analysis shifts from nontraded to traded services. The International Monetary Fund (IMF) considers only nonfactor services such as shipment, other transportation, travel, official services and other private services, as traded services. Excluded are direct investment income and other investment income which can potentially be included in traded services. The Philippines adopts a broader definition of nonfactor services or nonmerchandise trade (see Appendix Table 4A.2). Aside from investment income, it recognizes the fact that movements of labor across borders are an important mode used by Filipinos to export their technical services. Still, this definition is less comprehensive than what has been embodied in the GATS; that is, trade in services includes a supply of a service: (1) from the territory of one member into the territory of any other member (cross-border supply); (2) in the territory of one member to the service consumer of any other member (consumption abroad); (3) by a service supplier of one member, through commercial presence in the territory of any other member (commercial presence); and (4) by a service supplier of one member, through the presence of natural persons of a member in the territory of any other member (movement of natural persons).

Aside from the conceptual problem, the measurement problem is acute in the service sector, particularly the services sector of developing countries which are dominated by the informal sector. Because of this, there is a tendency to underestimate the contribution of the services sector to the economy. Some measures have been made by statistical agencies of these countries to address this problem. In the case of the wholesale and trade sector in the Philippines, for example, the National Statistical Coordination Board (NSCB) made an estimate of undercoverage separately for wholesale and retail to distinguish the structural difference between wholesale and retail trade and the gross value-added contribution of the unorganized sector, using employment data from the Integrated Survey of Households and the Annual Survey of Establishments.

The attention currently given by many countries to the services sector will eventually lead to more appropriate and universally accepted concepts and measurements.

II. PERFORMANCE OF THE SERVICES SECTOR

Global and Regional Perspective

A look at the share of the services sector by group of countries according to the World Bank classification shows that both developed and developing countries are basically service economies. There seems to be a positive correlation between the level of development of the economy and the share of the services sector. In 1990, the share of the services sector in the total output was little over one-third for low-income economies and over half for middle, upper-middle and high-income countries (see Table 4.1). Between 1970 and 1990, all four groups of countries had experienced a rising share of the services sector, indicating an increasing reliance on this sector. Growth in the services sector generally outpaced the growth in gross domestic product or GDP (see Table 4.2).

Table 4.1. Share of the services sector by group of countries (in percent)

	1970	1990	1992
1. Low-income economies	32.00	35.00	40.00
2. Middle-income economies	46.00	50.00	-
3. Upper-middle income	47.00	51.00	-
4. High-income economies	54.00	61.00	-

Source: World Development Report, 1982, 1992, 1994.

Table 4.2. Average growth of GDP and the services sector by group of countries (in percent)

	1970-1980		1980-1992	
	GDP	Services	GDP	Service
1. Low-income economies	4.50	5.70	6.10	7.10
2. Middle-income economies*	6.30	7.40	2.50	2.60
2.1 Philippines	6.00	1.20	5.10	2.80
3. Upper-middle income	6.00	6.20	2.60	2.70
4. High-income economies	3.20	3.70	2.90	-

Source: World Development Report, 1982, 1992, 1994.
* 1965-80 and 1980-90

The composition of the services sector of these countries is different. Those of low-income countries are dominated by the informal sector in trade and personal services using traditional technologies while those of high-income countries are characterized by subsectors including personal services that are knowledge intensive and which utilize more sophisticated technologies.

The Association of Southeast Asian Nations (ASEAN), excluding Brunei, can be characterized as service economies. Their services sector accounted for at least 40 percent of GDP in 1994. The highest is Singapore with 62.4 percent, which is to be expected considering the fact that Singapore is both a financial and a shopping center in the region. During the period 1980-1994, Indonesia, the Philippines and Singapore experienced a rising share in the services sector. In contrast, both Malaysia and Thailand experienced a decline in the share of their services sector mainly because of the rapid growth of their export-oriented manufacturing sector.

Table 4.3. Share of the services sector of ASEAN countries (in percent)

	1980	1994
1. Indonesia	34.30	39.80
2. Malaysia	41.30	39.80
3. Philippines	36.00	42.80
4. Thailand	49.70	46.80
5. Singapore	60.00	62.40

Source: Asian Development Outlook, 1991, 1995-1996.

Services in the National Economy

The Philippines' services sector appears to be the largest sector in the domestic economy. Its size increased during the period 1980-1994 . Its share in GDP increased from 36 percent in 1980 to 43 percent in 1994 (see Table 4.4). The growth rate of the services sector has been generally higher than that of GDP since 1980, implying that it has been pulling up the economy in the last 15 years.

The services sector is the second largest employer, next to agriculture. Its employment share increased from 33 percent in 1980 to 39 percent in 1994, absorbing most of the additional labor force that could not be accommodated by the agriculture sector (see Table 4.4). What is worrisome though is that like the industrial sector, its gross value-added per worker declined substantially during the indicated period. This suggests that a large segment of the additional labor going to the services sector had gone to the less productive subsectors, especially the informal sector, which employs very little capital and uses antiquated technology, thereby yielding very little value-added. This does not augur well for the development of the country. Rapid urbanization that is mainly characterized by a premature population shift from rural to urban areas in the face of the very low labor absorption rate by the industrial sector has forced thousands of people to take refuge in the services sector where petty jobs can be easily created.

Table 4.4. Production share, labor absorption and value-added per worker by major sector (selected years)

		1980	1990	1994
A.	Shares of Major Sectors			
	1. Agri., fishery, forestry	23.50	22.30	22.36
	2. Industry sector	40.52	35.46	34.83
	3. Service sector	35.98	42.24	42.81
B.	Labor Absorption			
	1. Agri., fishery, forestry	51.44	44.94	45.09
	2. Industry sector	15.58	15.40	15.77
	3. Service sector	32.99	39.70	39.14
C.	Value Added per Worker (in thousand pesos)			
	1. Agri., fishery, forestry	16.95	15.78	15.17
	2. Industry sector	96.51	75.65	67.55
	3. Service sector	40.47	33.35	33.45

Sources: National Income Accounts, various years; Current Labor Statistics (March 1995, December 1993); 1991 Employment Report.

Table 4.5 shows the value-added contribution of the major subsectors of the services sector. The largest subsector is wholesale and retail trade with a share three times larger than those of other subsectors. All subsectors realized an increase in their contribution to GDP during the period 1980-1994.

Wholesale and retail trade accounted for 15 percent of GDP in 1994, twice bigger than that of the next in rank among the services subsectors. The 1988 Census of Establishments (CE), the latest census data available to the public, reported that there were 9,173 establishments engaged in wholesale and retail trade with an average total employment of 10 or more.[2] This seriously underestimates the total number of persons actually involved in this sector because small establishments like *sari-sari* stores employing less than 10 persons and the self-employed like hawkers were excluded from the count. According to this limited coverage, 64 percent were engaged in retail trade and 36 percent in wholesale trade. Forty-eight percent of the total number of establishments were located in the National Capital Region (Metro Manila). The sector employed 217,067 persons, of which 42 percent were in wholesale trade and 58 percent in retail trade.

Table 4.5. Share of service sector in gross national product (GNP), selected years (in percent)

	1980	1990	1994
Service Sector	35.98	42.24	42.81
Transportation, communication and storage	4.78	5.70	5.87
Wholesale/ retail trade	13.01	14.91	15.27
Finance	3.94	4.16	4.12
Ownership of dwellings and real estate	5.19	5.57	5.55
Private services	4.90	6.85	6.94
Government services	4.16	5.05	5.06

Source: National Income Accounts, various years.

Private services, which may also be called professional business services,[3] contributed seven percent to GDP in 1994. According to the 1988 CE, there were 9,790 establishments with an average total employment of 10 or more in this subsector.[4] Forty-one percent of the total number of establishments in this subsector were located in the National Capital Region. The subsector employed 334,872 persons. Restaurants, cafes and other eating and drinking places dominated this subsector, accounting for 36 percent of the total number of establishments and 19 percent of total employment in the subsector. Although it ranked only second in terms of the number of establishments, the private education services accounted for 42 percent of the total employment in the subsector.

As shown in Appendix Table 4A.1, the private services subsector is the most heterogeneous subsector in the services sector. Some private service establishments are licensed or accredited by the government or professional bodies while others are not. Appendix Table 4A.3 shows an illustrative list of accredited and non-accredited professional business services. The Philippines has sufficient quantity and quality of domestic service suppliers for most of the accredited professional business services such as legal services, accountancy, engineering, etc. Among the non-accredited professional business services, market research and computer-related services and software development are the two budding subsectors. Ling (1990) estimated that in 1990 there were 20 market research firms in the Philippines employing about 400 people.[5] There is no accurate information on the number of firms involved in the computer services and software development subsector. Noyell (1990) showed that in 1990 there were 27 large computer services and software development firms and 22 large data entry and encoding firms in the Philippines employing about 20,000 people. Considering the rapid growth in automation in many industries and the trend toward outsourcing in the last five years, the number of firms and employed people in this industry must have increased five-fold. This industry has a large potential of becoming tradeable.

Transport, communications and storage is the third largest services subsector, contributing six percent to GDP in 1992. The 1988 CE reported that there were 1,430 establishments engaged in this subsector with an average employment of 10 or more, employing

a total of 141,775 persons.[6] Road transport and services allied to transport dominated this sector with 500 and 468 establishments, respectively. Fifty-nine percent of the total number of establishments in this subsector were located in Metro Manila.

One airline has dominated domestic air services. In contrast, several foreign-owned airlines aside from one Philippine-owned international carrier provide international air services. In 1989, a total of 5.4 million airline seats were flown on domestic routes and 3.1 million on international routes. The domestic shipping fleet comprises 8,805 vessels. In 1989, they carried more than 25 million passengers. There were 1.43 million vehicles across all classes 16 percent of which were primarily for public transport. The three most popular modes of transportation are buses, jeepneys and tricycle (motorcycle with a sidecar). There are about 400,000 tricycles in the country (probably employing the same number of people) providing transportation to 30 million people (Pineda 1993).

In telecommunications, 22 firms were engaged in mail and express services, 40 firms in telephone services, 16 firms in telegraph services, and 10 firms in communication services not elsewhere classified. Together, they employed 22,499 persons.

Among the services subsectors, finance had the smallest contribution to GDP in 1992. According to the 1988 CE, there were 2,420 banking institutions (including branches and extension offices) employing 62,203 persons, 361 nonbank financial intermediaries employing 10,336 persons, and 215 insurance companies employing 16,837 persons.[7] Although it has the smallest contribution to GDP, finance appears to be the most dynamic subsector in the services sector in the 1990s. Its growth rate averaged 3.06 percent during the period 1990-1994. Wholesale and retail trade is the second most dynamic subsector in the services sector in the 1990s. It grew by an average of 2.63 percent per annum, which is much higher than that of the entire services sector. The most sluggish subsector is ownership of dwellings and real estate which grew by an average of 1.68 percent during the period 1990-1994.

Interlinkages between Services and other Economic Activities

The discussions above underscore the important contribution of the services sector to total output and employment. But as mentioned earlier, the services sector plays a very important role in the development process through interlinkages with the rest of the economy. This section therefore tries to determine the extent to which the services sector is linked with the rest of the economy.

The input-output table can be used as an analytical tool to trace the interdependence among sectors of the economy. A sector supplying inputs to other sectors will also have demand for inputs from other sectors, thereby magnifying its effects on the entire economy. These can be measured by the sector's **backward linkage effects** which indicate the sector's importance as user of inputs from other production sectors, and the sector's **forward linkage effects** which indicate the degree by which the output of the sector is utilized by other sectors for further production. The former can be captured by the **index of the power of dispersion**, and the latter by the **index of sensitivity**. The results using the 1988 input-output table are summarized in Table 4.6.

As expected, the manufacturing sector has the largest backward and forward linkage effects. Among the services subsectors, the transport, communication and storage subsector has the largest backward linkage effects, followed by private services. Their expansion would have a considerable effect on other sectors. Ownership of dwellings and real estate has the lowest backward linkage effects. On the other hand, the private services subsector has the largest forward linkage effects, closely followed by wholesale and retail trade. These sectors have to produce more services than other subsectors to respond to any increase in the demand from other sectors. The government services subsector has the lowest forward linkage effects, which is understandable since most of its services are earmarked for final demand.

Table 4.6. Backward-forward linkage effects in the Philippine Economy: 1988

	Sector	Backward Linkage Index of Dispersion	Rank	Forward Linkage Index of Sensitivity	Rank
1.	Agriculture, fishery and forestry	0.8298986	9	1.6017625	2
2.	Mining and quarrying	1.0704802	4	0.7527414	6
3.	Manufacturing	1.2560534	1	2.9197305	1
4.	Construction	1.1267117	3	0.6979525	9
5.	Electricity, gas and water	1.0008286	6	0.7504059	7
6.	Transportation, storage and communication	1.1822400	2	0.8672475	5
7.	Trade	0.7945550	10	0.8897604	4
8.	Finance	0.8353239	8	0.7025258	8
9.	Real estate	0.7178205	11	0.6466624	10
10.	Private services	1.0114160	5	0.9193576	3
11.	Government services	0.9001052	7	0.5725441	11

Source: National Statistical Coordination Board (NSCB), The 1988 Input-Output Table, mimeographed.

In sum, although the degree of linkages of the services subsectors with other sectors greatly varies among each other, it clearly demonstrates the role of the services sector not only in contributing to GDP but also in stimulating production in and providing inputs to other sectors of the economy.

The degree of the responsiveness of the services subsectors to developments in other sectors of the economy has been determined. Here, the absolute contribution of each subsector was regressed on the absolute contribution of agriculture and industrial sectors using data for the period 1969-1994. To directly obtain the elasticities, a double log function was estimated. The results are presented in Appendix Table 4A.5.

Industrial production has a statistically significant positive effect on the production of all services subsectors. However, its impact varies across the subsectors. An increase in the production of the industrial sector by one percent leads to a 1.2 percent increase in the production of finance. In contrast, agricultural production does not have any impact on the production of the services subsectors. The exception is private services, but even then the sign of the elasticity coefficient does not conform to our *a priori* expectation.

These findings clearly support the point made by Puri *et al.* (1989) based on earlier studies that "the service sector is inextricably linked to and supportive of the manufacturing sector and that the there is no choice to be made between a manufacturing economy and a service economy" (p. 10). If the Philippines wants to improve the efficiency and competitiveness of its manufacturing sector, it must also enhance the efficiency and competitiveness of its services sector.

III. CONSTRAINTS AND POLICY ISSUES

This section examines some factors that inhibit the development of each services subsector and identifies some policies that can address those constraints.[8] It relies heavily on the findings and recommendations of existing studies.

A. Financial Sector

The financial sector has undergone substantial restructuring in the last ten years as a result of the crises that struck it (i.e., the Dewey Dee caper in 1981 and the balance-of-payments crisis in 1984-85) and the liberalization policies introduced since the 1980s. The lessons that can be drawn from this restructuring can serve as a useful guide to the restructuring of other services subsectors.

The financial sector used to be highly protected and pampered by the government. Although interest rates on both loans and deposits were regulated, this did not matter to most banks because they merely acted as conduits of government funds. For acting as conduits of government funds, banks were guaranteed a hefty spread, ranging from five to 11 percentage points. In effect, banks had no incentives to mobilize funds and allocate them efficiently to the best users. Competition was virtually absent because entry and branching were restricted. They were also assured of other money-making businesses. For example, export receipts were required to be surrendered to banks.

The process of liberalizing the financial sector was begun in 1981 and proceeded gradually. Interest rate ceilings on deposits and loans were removed in the early 1980s. By the mid-1980s, the rediscounting window of the Central Bank was rationalized so that banks could take their role of mobilizing deposits seriously. Toward the late 1980s, entry and branching by domestic banks, including rural banks, were deregulated. In 1994, a law was passed allowing 10 foreign banks to open six branches each in the country and raising foreign equity participation in domestic banks to 60 percent. Interestingly, small banks such as rural banks and thrift banks supported the move to encourage higher foreign equity participation to attract more foreign capital to the countryside and to professionalize the management of small banks. The increase in foreign equity participation in domestic banks was intended not only to bring in more foreign capital but also to accelerate technology transfer to domestic banks so that banks can become competitive both in the domestic and international markets.[9]

The response to this new policy environment has been positive. New banks have been established and several bank branches have been opened not only in urban areas but also in rural areas.[10] Several rural banks have opened branches in some areas where there are rural banks already—a move heretofore unthinkable. As a result, financial intermediation as measured by the ratio of M3 to GNP rose significantly from 24.2 percent in 1986 to 34.7 percent in 1994. Banks now offer a variety of financial services at more competitive rates. The foreign exchange deregulation has further exerted pressure on banks to be competitive.

Contrary to fears raised by several quarters before the liberalization of the banking sector, small banks have not been left out in this increasingly competitive financial market. For instance, rural banks' assets rose from 9.1 billion in 1986 to 27.6 billion in 1994. Moreover, rural banks' deposits as a percent of total assets increased markedly from 41 to 63 percent during the same period, implying that they are now mobilizing more deposits than in the past.

The amendments recently introduced to the Foreign Investment Act of 1991 have further liberalized the foreign ownership of some financial institutions. Because naturalized Filipinos have been given the same investment rights as natural-born Filipino citizens in thrift banks, rural banks and financing companies, these financial institutions can now be owned wholly by foreigners.

Notwithstanding these banking reforms, there remain some policy issues. One is that different banks are not put in the same level playing field. In particular, rural banks and thrift banks obtained more concessions from the government when the rural banking law and the thrift banking law were passed on the eve of the elections in 1992 and 1995, respectively. Rural banks and thrift banks have much lower reserve requirements on traditional deposits and are exempted from paying the gross receipts tax for five years.[11] The mandated loan quotas (i.e., 25 percent of the total loan portfolio of banks should be allocated to the agricultural sector and agrarian reform beneficiaries and 10 percent to small enterprises), together with a very high reserve requirement, have given banks very little

leeway to manage their loan portfolio.[12] This uneven treatment of banks, the high intermediation taxes and loan quotas need to be reviewed.

Aside from the direct services it provides to their clients, the insurance industry plays a crucial role in mobilizing long-term funds for the capital markets. But the growth of the domestic private insurance industry has been sluggish. Here, the problem is not market access. In fact, entry into the insurance industry by domestic firms has been very liberal. Beginning October 1994, foreign equity participation in domestic insurance companies can go up to 100 percent. But no foreign insurance firms are rushing to set up commercial presence in the country due to other regulations that have made the domestic insurance industry inefficient. Under the Insurance Code, the Insurance Commissioner is authorized to set the prices for fire insurance, motor car insurance and fidelity bonds. The insurance companies, which belong to one organization, influence the decision of the Insurance Commissioner. All members of the association apply one price for each of these products.[13] This is one of the reasons why the prices are much higher than those in other Asian countries. This pricing system needs to be liberalized so that the insurance industry can become competitive.

Prohibitive taxes on insurance premiums also raise the cost of insurance in the Philippines.[14] Other countries in the region have much lower tax rates on insurance premiums. Thus, there is a need to rationalize the taxes imposed on insurance premiums in the country.

In the process of liberalizing the financial sector, there is a need to strengthen prudential regulations to maintain the soundness and safety of the financial system. In the banking industry, for example, the Philippines should move toward the Bank of International Settlements (BIS) capital adequacy standards and other internationally accepted standards for measuring and managing various types of risks. In the stock markets, stronger regulatory measures are needed such as prohibition of trading by brokers who are also directors or officers of a listed company, and immediate dissemination of material facts and interim reports submitted to the Securities and Exchange Commission (SEC) by listed companies to

reduce potential gains from having access to inside information. In the insurance industry, there is a need to subject to prudential controls the investments, reserves and liability valuation of pre-need companies and to impose actuarial supervision of the risks associated with pre-need products.

With respect to the legal framework for debt recovery and insolvency, the existing laws and procedures are not conducive to lending. For instance, the judicial and extra-judicial disposition of foreclosed collateral is a long and tedious process generally in favor of the debtor. Partly because of this, banks tend to demand highly liquid collateral such as government securities, holdout deposits and shares of stocks. Under the existing Insolvency Law, there are many claims senior to debt that must be satisfied first. All this suggests that the existing legal framework for debt recovery and insolvency must be thoroughly reviewed with the objective of simplifying procedures for quick settlement of loan obligations.

B. Transport, Communications and Storage

1. Transport Sector

The domestic transport system in the Philippines may be divided into three major groups: the road transport subsector, the interisland shipping subsector, and the air transport subsector. The common major factors affecting the development of the three transport subsectors are infrastructure, market access and pricing regulations, equity investments and trade policy.

a. Road Transport System

The road network stimulates the development of the road transport subsector. According to Nathan Associates Inc. (1990), when road improvement projects are implemented, the road transport industries show themselves to be responsive to the new opportunities for providing reliable, lower-cost services. A reliable road network is important to the economy especially since producing regions are often far from consuming regions (Alburo, 1993). However, a significant proportion of the 160,000-kilometer road network is of poor quality and not properly maintained. Between 1983 and 1988, government

expenditures for road repairs and maintenance declined by 41 percent in real terms (Alburo, 1993). The bad road conditions increase the operating cost of vehicles by 50 percent to 95 percent and lengthen travel time by 60 percent to 110 percent (NTPP 1987).

The trucking industry appears to be competitive, largely because restrictive regulations have not been strictly implemented. For instance, trucks with "T" licenses (i.e., for own-account trucking) compete with trucks with "TH" licenses (i.e., trucks franchised by Land Transportation Franchising Regulatory Board or LTFRB to perform for-hire services).[15] Entry into the industry is fairly easy. More recently, the Department of Transportation and Communications (DOTC) simplified the franchising procedures and reduced the approval period to about one month. Approval is now almost automatic, thereby reducing franchising to a mere formality. The government does not set freight tariff rates nor restrict truck movements between islands.

Passenger road transport services consist of buses, minibuses, jeepneys, taxicabs and tricycles. The government regulates them in terms of company franchising, route licensing and fares. Entry into the industry is also relatively easy. In 1990, the DOTC simplified the documentary requirements and reduced the processing time for franchise applications. For instance, the documentary requirements for the application of a jeepney franchise were reduced from 21 to five items and regional applications for intraregional routes can now be processed in the regions concerned (Alonzo, 1991). The regulation of fares applies to the standard bus service, and fares for other modes of road transport gravitate around this. In most areas where roads are in good condition, the passenger road transport services are competitive and offer a variety of services to the travelling public (Nathan Associates, Inc., 1990). However, road safety regulations still leave much to be desired.

The trucking and passenger road transport services received a big boost in 1992 when the government removed trucks and buses from the list of the remaining regulated commodities. However, cars, motorcycles and parts still remain regulated. Interestingly,

Gwendolyn R. Tecson (1993) found that the assembly of cars and manufacture of motorcycle parts do not have comparative advantage. This certainly adversely affects the taxicab and tricycle industries.

The major issues in this subsector that must be addressed by policy are: the removal of the licensing and taxation differentiation between own-account and for-hire trucking; the liberalization of fare setting, specifically setting standard bus and jeepney fares within plus or minus 15 percent of a reference rate; the strengthening of road safety regulations; and the import liberalization of passenger cars and motorcycles. These can be done through legislative and/or administrative actions.

b. Interisland Shipping

The industry is regulated by the Maritime Industry Authority (MARINA), which has the authority to grant franchise privileges and to fix the rates, sailing schedules, routes and fares or freight rates. In the granting of franchises, MARINA has been guided by three rules:

1) Prior operator rule. This entails that an operator in a route will have the first option of introducing more capacity if market conditions warrant this. Any other operator wishing to introduce a vessel in a new route must demonstrate at a public hearing conducted by MARINA, either that the present operator is serving the route inadequately or that the new operator is introducing new technology or a much better service that the public should not be deprived of.

2) The protection of investment rule. An operator who is given a franchise will have five years to develop the route. During this period no competitor will be allowed to enter this route.

3) The capacity regulating rules. MARINA has the right to determine how much capacity is needed in all routes subject to franchising, and the owner/operator is allowed to change vessels or to introduce extra capacity only in accordance with these rules, which limits the increase to 20 percent of existing capacity.

These rules have severely limited the entry of new operators in the liner trades. Indeed, the industry has been characterized by an oligopolistic market structure. The Conference of Interisland Shipowners and Operators (CISO) consists of 17 members representing large shipping companies accounting for 80 to 85 percent of total liner traffic. The adverse economic consequences of this are inevitable. Nathan Associates, Inc. (1991) observe that, "Interisland shipping services in the Philippines are generally inadequate. Many desirable services are not yet being offered; standards of many services that are offered are low; service charges are higher than they would need to be if operations were efficient; and many maritime accidents occur" (p. 5). In short, the fares and freight rates fixed by MARINA did not allow enough incentives for operators within the same routes to actively compete.

In 1990, MARINA started the process of liberalizing the interisland liner shipping industry. Transport fare rates of first- and second-class passengers and the rates of livestock, transit and refrigerated cargoes have been fully deregulated, while a +/-15 percent fare range has been set for third-class passengers.

In 1989, quantitative restrictions on new ships and other vessels were removed. However, used vessels are still included in List C of Restricted Items for reasons of quality and safety (Mendoza, 1993). In 1991, tariff rates on vessels were reduced from three to 30 percent.

Shipping is risky considering the number of typhoons passing through the Philippines. But the major concern facing the industry is lack of capital. The lack of access to long-term capital has prompted shipping operators to purchase secondhand vessels instead of newly built ones.

c. Air Transportation

There used to be several privately owned passenger airlines in the 1960s. Despite the dominance of two airlines, competition was stiff especially in lucrative routes. In the early 1970s, the government adopted the one-airline policy for international and domestic operation, consequently forcing the merger of airlines, particularly

of the two leading airlines. Later on, the government took over the operation of the surviving airline, the Philippine Airlines (PAL) and, for more than 15 years, did not grant any franchise to a competitor to protect its interest in the airline industry.

The inefficiency of the airline is well known. Service is poor; flights are canceled without proper notification of passengers; flight delays are not uncommon; and long queues occur during peak seasons. Nonprofitable routes are operated for political reasons, and the additional cost is passed on to passengers in terms of higher fares.

In 1986, the government revoked the one-airline policy, paving the way for the entry of other carriers, particularly in domestic operations. Recently, the government sold 67 percent of the total equity shares of PAL to a consortium of private firms, thereby transferring the control of the airline to the private sector.

The most recent policy framework for the regulation of the transport industry is contained in Department Order No. 92-587 issued by the DOTC in March 1992. The order clearly aims to dismantle barriers to entry and exit and improve the pricing of services in the transportation industry. The salient features of this order are the following:

1) No franchise holder shall be permitted to maintain a monopoly on any route. A minimum of two franchise holders shall be permitted to operate on any route. Thus, the "protection of investment rule" has been abandoned.

2) The requirements for granting a certificate to operate have been greatly simplified.

3) The presumption of need for a service shall be deemed in favor of the applicant unless the oppositors can show proof that such service is not necessary. The "prior operator rule" and the "capacity regulating rule" have been abandoned.

4) There is no prohibition against exit.

5) The government shall not engage in special financing and incentive programs, including direct subsidies for fleet acquisition and expansion.

6) Operators may fix their own rates except for the lowest class of passenger service, in which case operators may fix the rate within the range of 15 percent below and above the reference rate set by the government.

This policy has already yielded some positive results. In the shipping industry, for instance, some operators have begun investing in more modern vessels and have deployed them to routes where they think they can make more profits. For example, Aboitiz Shipping Lines recently purchased two modern passenger vessels to enhance its competitiveness in certain routes. William Lines responded quickly by purchasing several luxury vessels with bigger capacities for both passengers and cargo. More recently, three large shipping companies have formed a consortium to systematize the services they offer and exploit some scale economies. They resorted to this action in anticipation of increasing competition in the shipping industry. Passengers now have an easier time making their bookings since the consortium's booking office offers more and varied shipping services. In the airline industry, the opening of domestic routes to competition has encouraged three new entrants. Air travelers will soon have more choices in terms of services and fares at least in routes where new entrants and PAL operate.

2. *Communications Sector*[16]

The telecommunications sector provides a range of services, including telephone services (voice), record services (telex, telegraph, data communications, etc.), radio paging services, and carrier services (satellite).

Reforms in the telecommunications sector were initiated in 1987 with the issuance of DOTC Department Circular No. 87-188. This circular contains a broad package of policy statements. However, it was only in the last three years that the government has exerted more efforts to accelerate the reform process by issuing several policy

measures intended to rationalize the telecommunications sector and improve its efficiency by encouraging more competition. The major policy measures are:

- The formulation and issuance in November 1992 of a government Policy on Cellular Mobile Telephone Service (CMTS) contained in DOTC Department Circular No. 92-269.

- The issuance of Executive Order (EO) No. 59 in February 1993, mandating interconnection of all public telecommunications and Memorandum Circular No. 9-7-93 outlining the implementing guidelines for the interconnection of authorized public telecommunications carriers.

- The development, and issuance in June 1993, of a Policy on Domestic Satellite Communications contained in DOTC Department Circular No. 93-273.

- The issuance of EO No. 109 in July 1993 and implementing guidelines to support the goal of providing universal access to basic telecommunications services, by requiring international gateway operators and providers of services which are possible sources of subsidy to also provide local exchange carrier services in unserved or underserved areas.

The National Telecommunications Commission (NTC) issued implementing guidelines for each of these measures and pursued several initiatives to liberalize the telecommunications sector. It would be worthwhile to review the implementation of competition policies and subsector market structure.

a. Satellite Services

In 1989, the NTC granted provisional authority to five companies to provide either satellite (VSAT) services or carrier type services. The two incumbent providers of domestic satellite services

strongly objected to this measure but NTC stood its ground, citing the need to improve the country's communications capacity. DOTC Circular No. 93-273 clearly spells out the liberalization policy on domestic satellite communications. In particular, Section 3 of the said circular states that:

> *Authorizations for the provision of satellite communications services are not to be limited to those satellite service providers currently possessing provisional authorities (PAs) or certificates of public convenience and necessity (CPCN). Any qualified applicant may apply for a CPCN/PA to install, operate and maintain any satellite related services.*

Recently, the private sector entered into a formal agreement with the government to launch a Philippine satellite. This is a privately owned project with the government acting as a facilitator. Accordingly, "the consortium or corporation shall have the exclusive right to provide space segments to Philippine users for their operations within the footprint of the subject satellite for ten (10) years from date of actual operation,..." Unlike Thailand where this privilege was given to a single telecommunications firm, the Philippine project will be carried out by a consortium of several telecommunication firms. Participation in this consortium is open to duly enfranchised telecommunications carriers. Moreover, the consortium shall provide satellite space segments in the Philippine Satellite to all interested parties in a nondiscriminatory manner.

Relatedly, DOTC is now working on the international satellite policy with the intention of opening up this market for more competition. It is envisioned that interested parties can have direct access to international satellite services, thereby ending the monopoly of Philcomsat.

b. Cellular Mobile Telephone Services (CMTS)

With the issuance of DOTC Circular No. 92-269 in 1992, the NTC has liberalized this subsector to expose the two incumbents to greater competition. Since then seven CMTS operators have applied for authority to provide CMTS services. NTC already approved three of them, thus bringing the number of players to five. Due to stiff

competiton, CMTS operators are now offering to the public services at a greatly reduced price. For example, PILTEL used to have a basic monthly charge of 750 for a particular plan, but this was recently reduced to 390.

c. Radio Paging Services

This subsector used to be served by a monopolist. Recently, however, NTC opened it up to wider competition. To date, there are already 11 radio paging service operators offering the latest technology.

d. Telephone Services

The Philippines has the second lowest telephone density among the ASEAN countries and the current backlog has already reached more than 700,000 lines. Growth in telephone service has largely been concentrated in urban areas, specifically Metro Manila. The investments required in this industry are huge. Until recently, the government considered this industry a natural monopoly.

Government regulation of the telephone industry includes company franchising, licensing and setting of rates. The Philippine Long Distance Telephone (PLDT) Company used to be the only operator of an international switching center in the Philippines. Recently, however, the NTC liberalized this sector and approved the applications of four firms to operate their own gateways, thereby bringing the number of players in this subsector to five.

The national long-distance service is still largely dominated by PLDT which owns and operates an extensive nationwide backbone transmission network. The government is currently developing an alternative backbone. The dominance of PLDT in this sub-sector has been somewhat diluted with the issuance of EO 59 mandating interconnections of all public telecommunications.

Recently the NTC, in consultation with seven MCTS/ International Gateway Operators (excluding PLDT), decided to divide the entire country into 11 service areas to accelerate the implemenation of EO 109. One of the seven MCTS/International

under this scheme Metro Manila is divided into four service areas which are allocated to four different MCTS/International Gateway Operators. Clearly, the intention is to have direct competitors with PLDT.

Admittedly, solving the monopoly in the telecommunications industry depends on enforcing the interconnection of telephone companies with the public switch telephone network controlled by PLDT. Although PLDT has abided by the regulation on interconnection, it has dictated the pace of interconnection, which many consider to be very slow.[17]

Aside from reducing barriers to entry into the telephone industry, some policy issues need to be addressed to improve competition and increase efficiency.[18] At present, the Philippines has a fixed tariff rate structure, which results in inefficient use of telephone facilities. Switching to a usage sensitive pricing system should be considered seriously especially in metropolitan areas to encourage subscribers to use their telephones more prudently.

In addition, the toll revenue sharing scheme is not reflective of cost. As competition heightens, the local exchange carriers will be more disadvantaged. It is therefore necessary to shift to a system in which interconnection settlement between carriers is based on cost and access.

Finally, the maximum 12 percent allowable return on rate base breeds some inefficiencies. An alternative scheme that induces regulated firms to be more efficient should be considered. One such scheme is the price cap regulation which seeks to control prices rather than profits.

C. Wholesale and Retail Trade[19]

Entry into the retail trade industry by Filipino citizens is virtually unrestricted. In fact, there are too many small retail stores in the country. However, many of them are poorly capitalized and inefficiently managed. More recently, large retail stores have sprouted

in a few major urban centers. Though professionally managed, these large retail stores are owned by a few families and put up very minimal competition among themselves.[20]

Our Asian neighbors have progressively upgraded and modernized their retail sector by liberalizing it. In particular, the entry of foreign investors into their domestic retail sector has been liberalized to enhance the benefits that the economy can derive from the sector, namely: increased consumer welfare through reduction in commodity prices, wider product array, and improved service; technology transfer; foreign exchange generation; employment creation; export promotion; professionalization of the retail trade sector; tourism development; and increased tax revenues (PDFI-Andersen Consulting, 1993). The Philippines lags behind its Asian neighbors in this area and consequently has foregone these expected benefits.

Three legal issues must be addressed to effect the liberalization of the retail trade sector. First, the Retail Trade Nationalization Law limits participation in the retail trade business to Filipino citizens. Although this has been circumvented by Chinese traders who were the original target of this legislation (AYC Consultants, Inc. 1993), potential foreign investors, especially known retailers in other countries who want to have greater control over their business operations and do not have any intention of changing their citizenship, are effectively barred from investing in the retail trade sector.

Second, land ownership is limited to Filipino citizens and corporations and associations at least 60 percent of the capital of which is owned by Filipino citizens. Foreign investors in large retail stores certainly prefer to own land, if not secure a long lease on the land on which their stores are located.[21]

Third, known foreign retailers entering the domestic market expect to be accorded proper protection in their use of their brandname and trademark. Several established retailers which bear brandnames or trademarks similar to those of foreign retailers will likely oppose this. There are, of course, other issues such as lack of telecommunications facilities and tariff and value-added tax

(VAT) rationalization which must be addressed to make the liberalization of the retail trade attractive to foreign investors (PDFI-Andersen Consulting, 1993).

There are other oppositors to the proposed liberalization of the retail trade sector. They have pointed out that retail trade will eventually be controlled by foreigners. However, there is a distinction between control of the industry and ownership of firms. If there is strong competition within the retail trade industry, Filipino consumers will assume effective control of the industry even if all the firms in the industry are owned by foreigners.

D. Private Services

The private services subsector is jealously protected by various statute laws some of which were enacted more than 30 years ago and others, only recently. Specifically, no foreign equity is allowed in mass media, services involving the practice of licensed professions, and private security agencies. Private recruitment, whether for local or overseas employment, and advertising are allowed to have foreign equity of up to 25 percent and 35 percent, respectively. Finally, foreign equity of up to 40 percent is allowed for the ownership or establishment of educational institutions requiring authorization by the Department of Education, Culture and Sports. This is also the case with services requiring a license or specific authorization, and subject to continuing regulation by national government agencies other than the Board of Investments (BOI) and Securities and Exchange Commission (SEC).

There is a need to review these restrictive laws. There are areas (e.g., accountancy, engineering, architecture, etc.) where Filipinos can compete very well and opening these up to foreign competition can further improve their efficiency. There are other areas where expertise is badly needed but Filipino firms or individuals cannot supply this. AYC Consultants, Inc. (1993) has pointed out that some skills needed to install modern, high-tech machinery in a factory are not taught in the Philippines. While a curriculum is being developed for these, the void can be temporarily filled in by foreign-trained professionals.

It might be worthwhile to mention here that an emerging business in the Philippines with a great potential for export is computer software and computer services. Data on this sector are scanty and not regularly published. Thierre Noyelle (1990) estimated that there were about 20,000 professionals working in the sector in 1990. The external market for computer software was estimated at between US$10 million and US$20 million for the last three years. The major exports are the United States and Japan. The largest firms in this sector have foreign equity participation. The computer software and services industry employs approximately 1,000 people.

The Philippines also exports data-entry/data processing services. Noyelle estimated that this industry exports between US$12.5 to US$ 25 million a year and employs about 5,000 people.

Aside from computer software and services and data-entry/ data processing, the Philippines exports computer professionals who work abroad on the basis of individual contracts. The number of contract computer professionals deployed overseas in 1988 was estimated at 800.

The possible export of the computer software industry raises the issue of intellectual property rights (IPR). Most individuals and local companies are using unlicensed computer software developed in other countries. Although laws on IPR are adequate, enforcement has been very weak. The government should address this problem to avoid unnecessary retaliatory measures by other countries that would adversely affect the thriving export business of the local computer software and services industry. The recent executive order requiring all government agencies to use only licensed application software is indeed a welcome development.

IV. CONCLUDING REMARKS

This paper has analyzed the role and performance of the Philippine services sector in the last two decades. The services sector's share in gross domestic product (GDP) and employment is significant and has been increasing. Some of its subsectors have demonstrated their dynamism, achieving growth rates much higher

than those of other economic sectors. Its subsectors have strong backward and forward linkages with the rest of the economic activities, particularly the industrial sector. Thus, the development of the services sector can stimulate and/or facilitate growth in other sectors of the economy.

The services sector has also demonstrated its potential as a foreign exchange earner for the country. The government should, therefore, give more attention to increasing the country's participation in world trade in services. Some subsectors are potentially attractive to foreign investors and this can enhance the marketability of producer services in the world market.

However, despite its enormous contributions to the economy, the services sector as a whole has the lowest productivity among economic sectors. The sector clearly needs to improve its productivity and bring the quality of services to world standards in order to be competitive. The liberalization of entry and pricing in some services subsectors is a step in the right direction. However, domestic resources are severely limited, and therefore responses to the new policy environment can be very slow. Clearly, the sector needs to open up to foreign investment and to foreign competition in order to attract an enormous amount of resources in a short time. In most cases, this would require changes in the laws covering foreign equity participation and land ownership.

As economic prosperity proceeds through the rapid development of the services sector, policy makers must be sensitive to the worsening income distribution it might produce. Raynor (1993) has pointed out that:

> *the service industries, in their current incarnations, provide opportunities for adding value that are either trivial or tremendous. Most service enterprises consist of a well-paid brain trust and poorly paid support staff—well-paid lawyers and poorly paid secretaries. This is not because those who are secretaries are unable to make significant contributions. Rather it is because the system within which they work ask only filing, typing, and phone answering of them, and these tasks alone*

> *cannot justify high wages. Uncommonly smart people are decidedly in the minority, so not everyone can make big money. At the same time, the systems in place in the service industries do not, by and large, encourage the small steps forward that have permitted continued high wages in manufacturing.* (p. 24)

While this phenomenon inevitably creeps into the calculation of the aggregate productivity of the sector, it nevertheless clearly suggests that there is some room for public policy for the sector.

NOTES

[1] Even before the 18th century, service industries played an important role in the countries of Western Europe (Puri *et al.* 1989).

[2]The census seriously underestimates the number of establishments in each sector because those with less than ten employees, which probably dominate the service sector and belong to the informal sector, are excluded.

[3]These are "services purchased primarily by other producers (i.e., by firms, not individuals) for the purpose of being consumed in further rounds of production... are mostly in the business of delivering expertise, necessitating a major input from skilled or highly skilled activities, some of which are restricted to licensed or accredited professionals, and others that are opened to all... can be delivered either by firms, ranging from very large to very small, or by self-employed professionals... even in international markets." (Noyelle, 1989 as quoted in Ling 1990).

[4]Note that in the 1988 Census of Establishments (CE), some of the private services, such as accounting and legal services, were included in the financing, insurance, real estate and business services sub-sector. The business services with an average total employment of 10 or more had 1,312 establishments employing 100,981 persons.

[5]Indonesia, Malaysia, Singapore and Thailand had a total of 34 market research firms.

[6]The 1988 CE also included establishments with less than 10 employees but used a sampling procedure.

[7]As of December 1994, there were 5,096 banking institutions and 5,863 nonbanking institutions.

[8]Government services are excluded from this discussion.

[9]In the past, technology transfer occurred indirectly and was widely diffused. That is, domestic banks recruited top officers from existing branches of foreign banks in the country.

[10]For instance, the number of commercial banks increased from 32 to 48 within a span of three years.

[11]Some rural banks that are approaching the size of a small commercial bank with several branches are enjoying these privileges.

[12]This has also discouraged some banks from mobilizing more deposits because they are encountering difficulties looking for credit-worthy small farm and nonfarm enterprises.

[13]Because of this, many have pointed out that there is a cartel in the insurance industry.

[14]Under the expanded value-added tax (EVAT) law, the premium tax has been raised from five to 10 percent. This is on top of the 12.5 percent documentary stamp tax.

[15]Often there is an extra cost incurred in bribing the police whenever they are caught in the highway.

[16]This draws largely from SGV (1992).

[17] If enacted into law, the bill now filed in Congress will compel officers and directors of telecommunication companies to allow interconnection with the facilities of their competitors within the period to be prescribed by the National Telecommunications Commission (NTC). This bill is obviously intended to give NTC more clout in breaking the monopoly in the telecommunications industry. This is accompanied by the Anti-Trust bill which is being endorsed by the Executive.

[18]This draws from Velasquez (1992).

[19]This draws from Policy and Development Foundation, Inc. (PDFI)-Andersen Consulting (1993) and AYC Consultants, Inc. (1993).

[20]Because large retail stores exercise monopsony power, small suppliers are unable to obtain a better deal from such retail stores. For example, retail stores pay suppliers post-dated checks. Due to lack of funds, suppliers often discount these checks with banks or informal money lenders (Lamberte and Jose, 1988).

[21]According to AYC Consultants, Inc. (1993), the most optimistic land requirements of foreign investors would constitute only 0.034 percent of the land in Central and Southern Luzon where most foreign businesses are located.

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Table 4A.1. Services Sector and Subsectors

1. Wholesale Trade and Retail Trade
2. Transport, Communication, and Storage
   - 2.1 Railway transport services
   - 2.2 Busline operators
   - 2.3 Public utility cars and taxicab operation
   - 2.4 Jeepney and autocalesa operation, tricycle and other road transport equipment
   - 2.5 Operation of tourist bus and cars and rent-a-car services
   - 2.6 Road freight transport & supporting services to land transport
   - 2.7 Ocean passenger and freight transport
   - 2.8 Interisland shipping including inland water
   - 2.9 Stevedoring & other supporting services to water transport
   - 2.1 Air transport
   - 2.11 Tour and travel agencies
   - 2.12 Customs brokers and other services allied transport
   - 2.13 Storage and warehousing
   - 2.14 Telephone
   - 2.15 Telegraph services
   - 2.16 Postal, messengerial and other communication services, n.e.c.
3. Finance
   - 3.1 Banking institutions
   - 3.2 Investment, financing companies, and other non-banking institution excluding pawnshops
   - 3.3 Pawnshops
   - 3.4 Life insurance
   - 3.5 Non-life and other insurance activities
4. Ownership of Dwelling Unit, Real Estate
   - 4.1 Real estate
   - 4.2 Letting, operating real estate, residential or non-residential, other real estate
   - 4.3 Ownership of dwellings

(continued next page)

Table 4A.1 (Continued)

5. Private Services
   - 5.1 Legal services
   - 5.2 Bookkeeping, accounting, and auditing services
   - 5.3 Engineering, architectural, and technical services
   - 5.4 Advertising services
   - 5.5 Machinery and equipment renting and leasing
   - 5.6 Employment/recruitment agencies
   - 5.7 Business management and consultancy and market research services
   - 5.8 Detective and protective services
   - 5.9 Other business services
   - 5.1 Sanitary and similar services
   - 5.11 Private education services
   - 5.12 Private hospital, sanitary and similar institutions
   - 5.13 Private medical, dental, veterinary & other health clinics and laboratories
   - 5.14 Other social and related community services
   - 5.15 Motion picture production
   - 5.16 Motion picture distribution and projection
   - 5.17 Radio and TV Programming
   - 5.18 Theatrical production and entertainment
   - 5.19 Other recreational and cultural services
   - 5.2 Repair shops for motor vehicles
   - 5.21 Other repair shops, n.e.c.
   - 5.22 Laundry, dry cleaning and dyeing plants
   - 5.23 Barber and beauty shops
   - 5.24 Photographic studios including commercial photography and related services
   - 5.25 Other personal services, n.e.c.
   - 5.26 Restaurants, cafes, and other eating and drinking places
   - 5.27 Hotels and motels
   - 5.28 Other lodging places
6. Public Services
   - 6.1 Public education services
   - 6.2 Public health services
   - 6.3 Public administration and defense
   - 6.4 Unclassified

Source: National Statistical Coordination Board

Table 4A.2 Non-merchandise trade

Non-Merchandise Trade, Net

Earnings
- Freight & Merchandise Insurance
- Other Transportation
- Travel
- Investment Income
  - Profits, Earnings & Dividends
  - Interest Income
    - Central Bank
    - Commercial Banks
    - Others
- Government
  - ESF
  - Others
- Non-Merchandise Insurance
- Personal Income
- Withdrawals of 343/547 deposits
- Commissions & Fees
- Construction Activity
- Operating Expense
- Other Services

Payments
- Freight & Merchandise Insurance
- Other Transportation
- Travel
- Investment Expense
  - Profits, Earnings & Dividends
  - Reinvested Earnings
  - Interest Expense
- Government
- Non-Merchandise Insurance
- Personal Income
- Commissions & Fees
- Construction Activity
- Other Services

Source: Department of Economic Statistics Bangko Sentral ng Pilipinas

Table 4A.3 Illustrative list of accredited and non-accredited professional services

This indicative list of accredited and non-accredited professional services has been used as a reference in the discussions in the Working Group on Professional Services in the Uruguay Round.

A. Activities generally considered to be accredited professional services:
- Legal professions (lawyers, solicitors, etc.)
- Legal advice/consultancy
- Accountancy services (accounting, auditing, taxation advice, insolvency)
- Architectural services
- Construction and engineering services
- Quantity surveyors
- Health services (e.g. medical and veterinary practitioners, nurses, pharmacists,
- dentists, opticians)
- Linguistic services (e.g. interpreters)
- Others (e.g. estate agents, patent agents, actuaries, notaries, stockbrokers,teachers, psychologists, tourist guides, criminologists, journalists)

B. Activities generally considered not requiring accreditation and often referred to as business services:

Marketing services
- Legal advice/consultancy
- Advertising, direct marketing and sales promotion
- Market research and public opinion polling
- Public relations
- Fairs and exhibitions, other marketing services

Consultancy services
- Management and administrative services
- Computer-related services and software development
- Recruitment consultancy
- Training and education services/consultancy
- Other specializations (e.g. mining,/geology, agriculture and fisheries)

(continued next page)

Table 4A.3 Illustrative list of accredited and non-accredited professional service (Continued)

Operational services
• Legal advice/consultancy
• Provision of personnel (e.g. secretarial, temporary labour)
• Contract cleaning services
• Waste disposal and processing
• Security services
• Translation services
• Other operational services
Other technical services
• Maintenance and repair of equipment
• Quality control and inspection
• Testing and certification
• Design
• Photographic services, commercial art
• Other technical services
Other business services

Source: Services in Asia and the Pacific Selected Papers Vol. I, United Nations Conference on Trade and Development, UNDP.

Table 4A.4 Growth rate of gross value added in services, 1980-1994 (in percent)

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
Total Services	6.11	1.916013	6.820113	5.557439	-6.53079	-2.07742	4.226084	5.232524	7.15787	7.031463	4.856533
Trans., Comm. & Storage	4.26	4.983719	2.566195	3.842114	-1.72276	-1.22895	4.449567	6.080121	8.014593	6.187662	2.149442
Trade	6.07	0.221844	8.586233	3.939169	-6.79972	-0.95891	4.927869	3.590782	5.710922	7.931288	4.574171
Finance	11.39	-13.4691	5.507944	13.8861	-19.4214	-14.8533	8.141097	15.92051	11.08782	14.32585	9.929937
O. Dwellings & R. Estate	5.35	0.467541	7.200579	1.759892	-6.07615	-1.39021	3.33935	4.680018	5.558273	6.51931	2.719853
Private Services	5.37	13.00174	9.279815	14.54846	-6.58091	-0.97454	2.553616	4.835494	7.705659	4.929251	3.826735
Government Services	5.45	6.990138	3.94145	-1.23089	-0.23344	0.44998	2.852638	3.526132	8.78433	3.517728	8.804806
Real GDP Growth Rate	5.15	3.423269	3.619328	1.874616	-7.32368	-7.30661	3.416783	4.312142	6.75235	6.20514	3.037105

	1991	1992	1993	1994	1980-1985	1985-1990	1990-1994	1980-1994
				A	V E	R	A G	E
Total Services	0.150455	1.023069	2.486152	3.840415	1.965892	4.40	2.471325	3.186661
Trans., Comm. & Storage	0.445169	1.402243	2.557917	4.585361	2.11672	4.28	2.228026	3.23816
Trade	0.534311	1.646266	2.457643	3.951884	1.843104	4.30	2.632855	3.09225
Finance	-2.84971	0.353782	2.368484	5.473269	-2.82664	7.43	3.05 5153	3.186081
O. Dwellings & R. Estate	0.239127	0.72561	1.813293	2.917444	1.218608	3.57	1.683065	2.388262
Private Services	-0.1621	0.564204	2.89197	4.266044	5.774095	3.81	2.277371	4.403696
Government Services	1.483313	0.240899	2.775828	1.818086	2.561206	4.66	3.024586	3.278066
Real GDP Growth Rate	-0.57847	0.337463	2.116168	4.295551	-0.09385	2.74	1.841563	1.95541

Source: National Income Accounts

Table 4A.5. Responsiveness of the production of services to changes in agricultural and industrial production

	Trade	Transport	Finance	Housing	Private Serv	Gov't. Serv
Constant	28.25661 (0.0845)	4.85764 (3.4155)	-8.499148 (-2.0346)	9.9026 (5.2889)	-39.36952 (-0.0349)	8.848067 (3.3449)
Agriculture	-0.14968 (-0.7588)	0.188438 (1.4026)	0.289764 (0.6337)	-0.288724 (-1.3299)	-0.707761 (-2.6046)*	0.034783 (0.1676)
Industry	0.431855 (4.5753)*	0.329286 (5.0847)*	1.220527 (4.3202)*	0.292307 (2.9945)*	0.551391 (4.1951)*	0.192217 (1.9367)**
Adjusted R-squared	0.99405	0.997997	0.964195	0.967947	0.9922	0.991463
Durbin-Watson	2.3135	1.149493	2.016302	2.113071	1.5497	1.759039
F-statistic	1339.548	3987.641	216.4338	242.5899	1022.562	930.1186
Return to Scale	0.282175	0.517724	1.510291	0.003583	-0.15637	0.227

* Significant at 1% level
** Significant at 10% level

Source of basic data: National Income Accounts, 1969-1994 (regressed)

COMMENTS

Vaughn Montes[*]

Dr. Lamberte's paper is a comprehensive coverage of the service sector which succeeds in bringing out the salient issues. First, he established the significance of the services sector to the economy. Ours is in fact a service economy. This has certain implications for the kind of development strategy we should adopt. Of course, as Dr. Lamberte pointed out, the service sector grew almost by default. It grew because of the failure of the manufacturing sector to absorb labor that was migrating out of agriculture. But the bloated services sector is saddled by low productivity due to the fact that it is under-capitalized. There seems to be insufficient investment in this sector.

It is part of the nature of the services industry that monopolies arise. But because of the protection they enjoy, there is no profit-maximizing. Local investors in the sector are running their assets to the ground to extract the marginal value of their investments, in the process undermining safety and competitiveness. For instance, you have these second-hand ships manned by a second-rate crew and the next morning you have these terrible pictures of drowned babies. The impact of all of these is that the service sector is not able to service the other sectors.

A second point is that the dichotomy between tradeables and non-tradeables in the service sector is perhaps artificial. For example, we have a very tradeable, efficient, and competitive manpower service sector in our overseas contract workers. I think Filipino labor has proven itself to be highly flexible, mobile and world-class even as Filipino capital and management continues to be protected, uncompetitive, and inefficient. And were it not for the safety-valve of overseas employment, the political pressures in the Philippines would have been much greater over the past 10 to 15 years. Our trade deficit is reduced by the inflows of remittances by our OCWs. Overseas employment has bought the country's leadership time to get their act together. But it is most regretful that we call OCWs the heroes of the economy even as the dollars they remit home are being used to support the conspicuous consumption of the upperclass who have proven themselves to be uncompetitive and inefficient. As economists, we need to highlight this point.

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[*] Vice-President, Citibank N.A. (Philippines)

Dr. Lamberte comments that services are very hard to monitor. But to see how well the sector has expanded, we only have to look at the classified ads every Sunday. The Singaporeans are advertising their need for computer service professionals. This points to the fact that there are many services which used to be non-tradeable but with technological advances, are fast becoming commodity items globally. It's a question of pushing the service sector towards the efficient margin of the economy.

In many of the sectors analyzed by Dr. Lamberte, the prescription is more liberalization to encourage investments in physical capital and people and thereby upgrade the productivity and quality of the service sector. An aggressive deregulation stance will tend to provoke "Schumpeterian competition." A prime example is the banking industry where liberalization has resulted in the influx of foreign banks. Consequently, local banks are investing in people, in technology, and in upgrading their services, in an effort to preempt competition from the foreign banks. Another example is the shipping industry. A month or two ago, the three major players in the industry—William Lines, Gothong, and Aboitiz—formed a conglomerate in reaction to the liberalization of the shipping industry. By doing so, they were able to reprogram their schedules to improve passenger services and maximize their carrying capacity. They will be able to internalize the benefits of coordinating with each other in contrast to the alternative of cut-throat competition which results in fewer trips per week, among others.

There are natural monopoly elements in the service sector which require some degree of inter-agency planning and policy coordination. The default solution would be more competition. The role of government would simply be ensuring that this comes about.

We also need to strengthen our regional advantages. To cite a specific example, Citibank has announced its intention to relocate its training center from Singapore back to Manila not only because of the lower cost of the hotels and the nice people, but also because we speak English and have many banking professionals who can teach in this institute.

Finally, let me suggest further research into productivity in terms of unit labor cost and capital-labor ratios which will give us a handle on what is really going on in the service sector. If this is done across service industries and across countries for a given service sector, then we may be able to highlight the fact that there really is under-capitalization in the service sector because of lack of competition and insufficient liberalization.

COMMENTS

Johnny Noe Ravalo*

First, my general comment is that efficiency should be the be-all and end-all. We are blessed with so much manpower. The problem is converting all that into productivity. In a very recent paper covering about 15 countries, the idea was put forward that if wage were the only factor, there should be a sizeable migration of companies to low-wage countries like the Philippines. And yet the data clearly show that there is no such migration. There is an implicit ratio between the wage rate and efficiency. Ours is one of the lowest and in effect also one of the least productive.

That same paper suggested that part of the solution is to liberalize or "allow foreign participation" in various forms. There are suggestions of allowing foreigners to put up investment houses in which they will have 100 percent equity—a situation unheard of anywhere in the world except the Philippines. However, bringing in capital to increase efficiency is not a convenient solution in the short run. In the long term, it may be a viable solution. But what really counts is efficiency of the local supply, of local labor and capital.

There is agreement over the fact that Filipino workers are highly competent and globally competitive. This is evidenced by their success abroad. But I think that Filipino labor behaves differently—that is, with less discipline—at home. Of course, this is not an economic issue.

I have three specific comments. First, on the finance sector. In view of the large volume of daily financial transactions, I find it surprising that the value added for the finance sector is the third or second lowest among seven or eight sectors. It is also surprising that Dr. Lamberte's table shows the finance sector as having very weak forward and backward linkages. This probably reflects the periodicity of the data. We tend to look at data on an annual or quarterly basis, or from one end point to another. But the real issue in finance is not where you begin or where you end but how you get there. In technical terms, it is not so much an issue of steady states but of transition paths. This is where all the dynamics will show up.

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As for the entry of foreign commercial banks, there is the problem of local banks losing key people, treasurers, to foreign banks who are offering them very generous remuneration packages. The local banks now have the problem of upgrading their personnel. This is not easy especially because the technical skills of a treasurer, for instance, are the product of long years of training on-the-job. In this sector, therefore, education programs are vital as a medium to long term solution. On the other hand, there has been a kind of reverse brain drain where banking personnel who have worked years abroad are coming home. This is a trend we would like to see continued.

The second sector I would like to comment on is the government services sector, particularly traffic law enforcers. This group appears to have very little clout: their no-entry signals are ignored by motorists because they have no power to issue tickets, for example. The point is that we have so much labor wasted. Industry is moving towards high-technology and capital-based production. What we can do is to retrain our workers in new skills. This requires a real national skills development policy.

Finally, on the computer sector which Dr. Lamberte correctly identifies as a boom sector. There is a great demand for Filipino computer professionals in countries like the U.S. It's a shame that such highly skilled human resources are being pulled out of the country. The emerging world situation places a great premium on talent and talent is not abundant anywhere else. We must replenish our pool of highly skilled human resources by investing heavily in education.

5. Tradeable Services with Increasing Returns: Some Implications for Liberalization

*Nimai M. Mehta**

INTRODUCTION

The presence of increasing returns in the form of economies of scale and division of labor has been given increasing attention in economic growth and international trade literature (see the contributions in Buchanan and Yoon, 1994). The hypothesis has been utilized to explain phenomena such as endogenous growth, intra-industry trade, firm location decisions, among others. This paper employs the increasing returns hypothesis to highlight the role of producer services — i.e. services used as intermediate inputs in the production chain either between or within firms — in a growing economy, and to suggest some policy positions regarding liberalization of trade in services. Final consumption services such as medical care and tourism are not discussed here on the assumption that the increasing returns hypothesis is not valid for these services. Trade services, particularly retail trade, though also not properly a producer service, will nevertheless be considered here given the large share of these services in the output of developing countries.

Section I presents an overview of recent concerns regarding trade in services, and proposes that the quality of nontradeability associated with services is the result of artifactual rather than inherent barriers to trade in services (as opposed to goods). Section II introduces the hypothesis of increasing returns through Smithian models of specialization and division of labor. The process of economic growth and the role of services in this process are analyzed. The nature and extent of complementarities between producer services

* The revision of this paper benefitted from the comments of Dr. Gilbert Llanto and the other Conference participants.

and economic growth is shown to be a function of the stage of division of labor within the economy. Section III compares the sectoral growth pattern experienced by the Philippines in the last decade and a half with that of its more advanced neighbors in order to identify relevant policy priorities. Finally, associate policy perspectives are spelled out in Section IV, including policy issues arising within the context of the multilateral General Agreement on Trade in Services (GATS).

I. BACKGROUND

The literature on services, initiated by the early contributions of Colin Clark (1951), Alan Fisher (1939), and Kuznets (1971), has typically considered services as nontradeable[1] for conceptual and historical reasons. Conceptually, nontradeability has been viewed to be a defining aspect of "services" as opposed to "goods" (see Hill, 1971), though the issue of nontradeability remains unclear. Historically, trade in services was either considered unimportant, as services represented a still insignificant share of gross domestic product, or was constrained by the presence of artifactual barriers (as is still the case in a majority of countries). However, both the conceptual and historical notions of nontradeability have come into question since the 1980s. Technology has been an important common factor both in weakening the conceptual assumption of service nontradeability and in undermining the historical role of protection and regulation. Specifically, innovations in data processing and communications have made possible cross-border trade in a range of services (Lanvin, 1993). At the same time, with access to such service flows becoming an essential prerequisite for the efficient performance of the goods sector, the perceived cost of protectionist measures has increased by a large factor (see McKenzie and Lee, 1991). Incidentally, the essential role of trade in services in a modern economy was recently underscored by the shock of the international community in the face of the Chinese government's proposal to censor financial and other economic information flows to the mainland.

A concurrent and somewhat related development has been the progress, particularly in Thatcher's United Kingdom and Reagan's United States, of the deregulation-cum-privatization of public utilities

and services. The privatization of public enterprises in the transport and telecommunications sectors has naturally dampened the protectionist zeal traditionally displayed in service sectors. Furthermore, technological innovations have potentially increased the degree of contestability in some of the service industries, thus curtailing the dangers of a natural monopoly and the need for regulation (see Baumol and Lee, 1991). A good example is the mushrooming of the so-called "call-back" telephone services offered to local telephone subscribers by off-shore firms. Finally, the increasing share of the service sector in the gross national product of industrialized countries has induced trade enthusiasts from the industrialized world to push for a multilateral regime for trade in services.

These developments have brought the issue of tradeability in services to the forefront of the recent debates in the trade literature, along with a host of new questions: Has technology turned non-tradeables into tradeables? Is nontradeability no longer the essence of services? Indeed, the latest United Nations Conference on Trade and Development (UNCTAD) and World Bank *Handbook on Liberalizing Trade in Services* (1994) no longer views the distinction between services and goods as essential. Can trade in services then be explained by the theory of comparative advantage as commonly applied to goods? And what is the link between services, trade, and development? Answers to these questions are still provisional.

I shall claim here that the reasons for limited trade in services between countries are mainly artifactual and do not essentially depend on the nature of services nor on the level of technological progress. Therefore, the determinants of trade in banking services between countries for example, are not dissimilar to those affecting trade within a country nor to those characterizing trade in goods: if the volume of banking trade within a country is a function of the number of branches and banks established, it is only a restriction on capital movements that would affect the latter and decrease trade both between and within countries. Consistent with this view, the recent literature on service trade liberalization does equate increased tradeability with unfettered movements of capital and labor between countries. Thus, trade liberalization is seen to encompass cross-border trade, consumer movements to the source of supply, temporary

movements of service providers to the point of consumption, as well as the establishment of commercial and production facilities in a foreign country (UNCTAD, 1994; Bhagwati, 1987; Hoekman, 1995). Of course, considerations of transport and communication costs enter trade decisions within and between countries both for goods and services. Ultimately, a distinction between (and among) goods and services and intra- and inter-country trade may reflect merely the associated level of transaction costs which are only **empirically** determinable.

Regarding the question of the suitability and sufficiency of the theory of comparative advantage in evaluating the gains from trade in services, the few investigations to date into this issue (Deardoff, 1984; Hindley and Smith, 1984) seem to offer no strong reservations.[2] What is missing, though, is a clear extension of the conventional gains from a trade perspective to an understanding of how trade in specific services bears upon economic productivity and growth. Instead, the increasing returns hypothesis provides a firmer link between trade in services and growth than is possible with the theory of comparative advantage based on a constant returns assumption.

II. GAINS FROM SPECIALIZATION AND DIVISION OF LABOR

The presence of increasing returns in its simplest form can be illustrated by utilizing Smithian models of specialization and division of labor. At the same time, these provide a fruitful basis for evaluating the growth gains from an increased tradeability in services.

In Adam Smith's story, trade between individuals (or nations) is not motivated by inherent or preexisting comparative advantages. In fact, Smith views individuals as being not very different in their "natural talents" which are shaped by their adopted specializations made possible through trade. Trade is valued in this model since it allows for productivity gains that accompany specialization and division of labor. The division of labor, however, is limited by the "extent of the market." Extending the market induces productivity gains which, in turn, lead to a further widening of the circle of

exchange. The role of producer services in this widening may be illustrated through four stylized models of specialization and division of labor presented below.

Figure 5.1 below shows the shift from a condition of self-sufficiency (A) with each worker-consumer—W1, W2, W3—self-providing three goods —P, Q, and R—to a craft-type specialization of work (B) where each worker specializes in the production of a single article. Each worker in (B) develops a specific routine of tasks—1, 2, and 3—toward the production of the good. The gains from such specialization derive from an increase in the knowledge and skills associated with the tasks required for the production of an article, along with the development of specialized tools. What sustains this form of specialization is the possibility of trade between the three workers-consumers and a **minimum** production scale, and therefore,

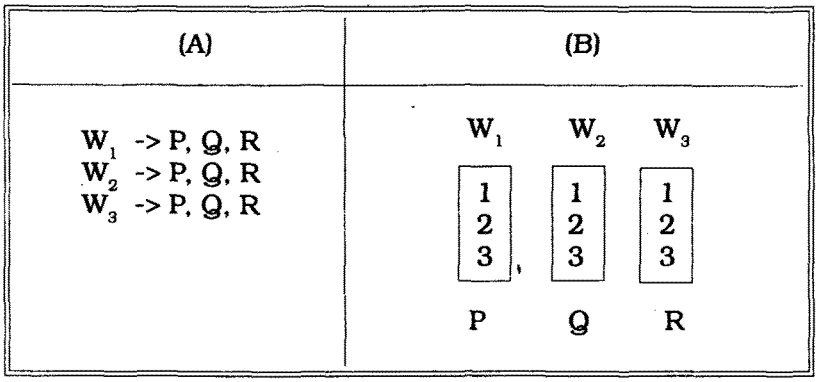


Figure 5.1

a minimum market size which in this case is assured by the assumption that the bundle of goods consumed and produced in (B) is the same as in (A).[3] Services such as retail and wholesale trade, transport, and rudimentary credit markets play an important role in this stage of specialization. Growth within a geographical region and over time occurs as this shift from self-sufficiency to specialized production is reproduced progressively in similar communities of

workers-consumers. However, the growth in real per capita income that occurs with the diffusion of (B) is mainly a one-time increase and is limited by the extent of productivity gains realizable through (B).[4] At the same time, these gains will be shared by a rising number of individuals participating full-time or part-time within the tertiary sector (see, for example, Bauer and Yamey, 1951). Thus, an increase in the output and employment share of the tertiary sector coincides with a minimum and limited productivity gain in the manufacturing sector. Given limited productivity gains in the latter, the former is typically characterized by the employment of unskilled, low-wage labor with minimum capital.

In contrast, Figure 5.2 displays a model of division of labor (C) that Smith associated with the proverbial pin factory.

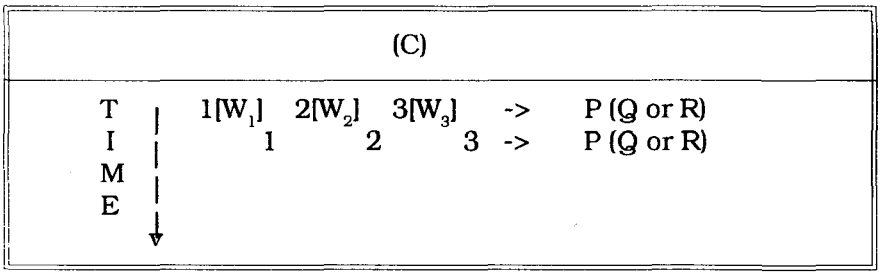


Figure 5.2

In (C), each worker-consumer specializes in a single task or operation within the same firm (for example, W_1 specializes in task 1). As Smith noted in his descriptions of the pin factory, a substantial and progressive increase in productivity is achieved through division of labor due to the following: (1) improved dexterity in performance of tasks; (2) time saved in not having to switch between different tasks; (3) and mechanization of tasks, leading to invention and innovation. The latter, according to Smith, can occur either within the firm as a result of attempts by production workers to solve highly specialized problems, or by the application of "speculative reasoning" on the part of scientists. Furthermore, the mode of division of labor in (C) allows for the realization of scale economies in the presence of "unbalanced

capacities:" if worker W3 (or machine M3) can work at twice the pace of the other two workers, then the output can be doubled by employing just five workers as shown by (D) in Figure 5.3.

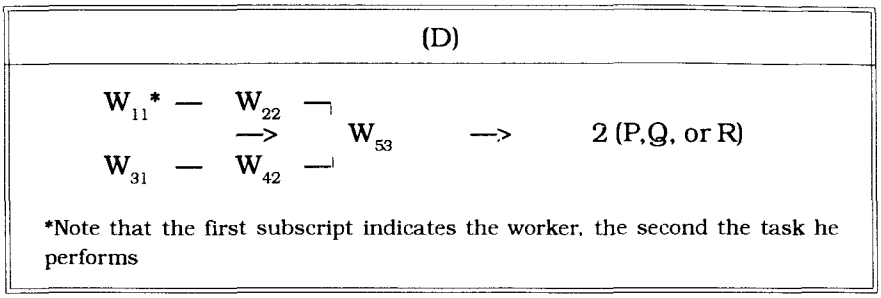


Figure 5.3

The implications for producer services of a shift from specialization (B) to division of labor (C) is revolutionary. In (B), the relation between gains from specialization and size or extent of the market is defined by a **minimum**. Beyond the minimum required services that facilitate trade between specialized producers and consumers, further increase in the volume or efficiency of the service sector has little significant effect on the productivity of the manufacturing sector. Therefore, without the emergence of type (C) and (D) production structures, the tertiary sector lacks an incentive to increase the average firm size or make productivity enhancing investments. The Smithian proverb, "division of labor is limited by the extent of the market," comes into its own only with mode (C) type division of labor. Here, the productivity gains from the serially arranged production process in (C) and the scale effects shown in (D)—which are mutually reinforcing— are a function of market size. An increase in volume and efficiency of trade, finance, transport, and communications (that is, of producer services) allows for the realization of increasing returns to the existing set of factors in (C) and economies of scale in (D). Secondly, with division of labor a whole new set of producer services becomes essential as the requirement for external market coordination is replaced by the need for internal coordination of the activities of different factors within the firm. Different dimensions of coordination are supplied internally by a new set of services: cost accounting, personnel management,

production planning and design, marketing, and others. The sustainability of division of labor thus depends upon efficient coordination provided by these services.

To complete this sketch of the evolution of the tertiary sector as specialization and division of labor emerging in the tradeable goods sector, we need to consider a fourth and final production structure characterized by increased "roundaboutness," as in (E) in Figure 5.4.

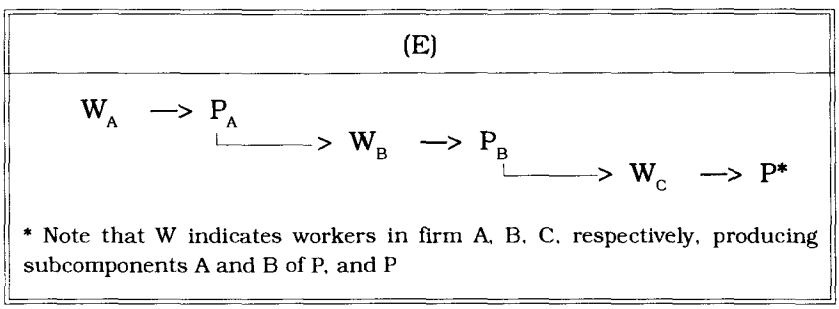


Figure 5.4

The set of individual tasks displayed in (C) may become further divisible into new, more specialized subtasks performed by the same or by different firms. This subdivision into more specialized subtasks, if they are performed within the same firm, may increase the extent of realizable scale economies by enhancing imbalances of type (D). If it involves separate firms, such increased roundaboutness will depend upon the ability of the economic system to supply the necessary degree of coordination among complementary activities offered by different firms through technology transfers, joint product development, royalties, licensing agreements, supplier credits, and others. This will imply a further tier of tertiary sector development. Thus, while for (B) mode of specialization trade services ensure the minimum coordination necessary for its sustainability, for (C), (D), and (E) producer services directly impinge on the productivity of these modes of division of labor.

Furthermore, as the economy grows, the same logic of division of labor will start operating in the production of services, as some service functions "splinter off" (Bhagwati, 1984) from firms and become established as independent operations. While some services may enjoy productivity gains similar to mode (B), others such as transport, banking, and communications are also able to realize substantial economies of scale along various dimensions, including network economies, economies of scope, capital economies, and others. The coincidence of continuing (or increasing) growth with a rising share of the producer services in national output is thus explained by the cumulative progress in the extent of division of labor in an economy.

III. SOME EMPIRICAL EVIDENCE

The growth experience of the newly-industrializing countries in the last decade and a half testifies broadly to the nature of complementarities indicated in this paper between services and growth in the goods sector. The high gross domestic product (GDP) growth rates of between seven to 10 percent (see Appendix Table 5A.1) obtained by Singapore, Malaysia, Thailand, and Indonesia have been accompanied by a common pattern of sectoral change: a high growth rate of real value added in industry and manufacturing (Appendix Tables 5A.2 and 5A.3) that has coincided with similarly high annual growth rates of real value added in the service sector (Appendix Table 5A.4); an increase in the share of the service sector in gross domestic product (constant prices) (Appendix Table 5A.5);[5] a fall in the total service output share of the trade (wholesale and retail) sector; a substantial increase in the shares of the finance, transport and communication sectors; and a fall in the share of public administration and "other services"—these two representing mainly, final consumption services (refer to Appendix Tables 5A.6 to 5A.9 for country data). In the late 1970s, trade (wholesale and retail) dominated the service sector in all four countries with its share in the total service sector output ranging between 25 percent (constant prices) and 44 percent. By 1993, the share of trade in total service output had fallen in all countries, with the exception of Malaysia which recorded a small increase (from 27 percent in 1977 to 30 percent in 1993). The share of the trade sector in the respective

country GDPs (constant prices) also registered decreases over the period, with the exception of Indonesia which exhibited a small increase (Appendix Table 5A.10). In the same period, the largest increase for these countries was in the share of the finance sector in total service output from an average of 16 percent in 1977 to an average of 28 percent in 1993. Transportation and communications recorded the next largest increase, rising from about 13 percent in 1977 to an average of around 18 percent in 1993. At the same time, the share of public administration and other services fell in all countries.

That the Philippine experience provides a sharp contrast to that of the countries just discussed, lends empirical support to our analysis. The Philippines obtained a relatively low average annual GDP growth rate (only 1.7 percent) during the period 1981-1994.[6] A striking aspect of sectoral change in the Philippines has been the absence of a coincidence of growth in the service sector with a growth of GDP or of value added in industry and manufacturing. Instead, the growth of value added in the service sector has been consistently higher than that in industry, manufacturing, and of GDP (Appendix Tables 5A.1 to 5A.4). The opposite has been true for Malaysia, Thailand, Singapore and Indonesia.[7] Even more significant is the positive growth rate registered by the Philippine service sector, while industry experienced negative average growth during the 1980s (Appendix Table 5A.2 and 5A.4). These aggregate trends in the growth data for the Philippines[8] may be better analyzed by considering two relevant predictions underscored in our analysis in Section II:

1. The lack of a significant growth effect of increases in the output and employment share of the trade (retail and wholesale) sector; and

2. An increase in the share of producer services coinciding with economic growth.

The sectoral data available seem to confirm, if not direct the causes of the relatively disappointing performance, most of the symptoms of low growth recognizable now with the hindsight gained through our model. Retail and wholesale services, which have dominated the service sector in the Philippines with a share of 34 to

36 percent (constant prices) of total service sector output, increased their share in GDP from 12.3 percent in 1977 to 15.3 percent in 1994 (constant prices). The percentage share distribution of other services in total service output (constant prices) in 1993 was as follows: final consumption services, including government services, approximately 41 percent of total service sector output; transport, communication and storage, approximately 14 percent; and finance and insurance, 9.5 percent. Thus, in direct opposition to the service pattern trends observed among the newly-industrialized countries, the share of finance and insurance remained very low, while that of trade and final consumption services remained high.

To summarize, this preliminary investigation into the growth performance of the relevant sectors in the Philippines indicates, at an aggregate level, both the inability to obtain significant productivity gains from the existing division of labor and the underdeveloped extent of division of labor in the Philippine economy. The imperatives for liberalization of producer services along with the removal of policy or market distortions that sustain these observed biases toward trade and final consumption services are thus stronger for the Philippines than for its more developed neighbors.

IV. MATTERS OF POLICY

The preceding presentation of the very divergent growth pattern experienced by the Philippines as compared to its more developed neighbors indicates the following broad concerns for policy:

1. The relative inefficiency and/or the comparatively small share of producer services in the Philippines.

2. The continuing relative dominance of the trade (retail and wholesale) sector in the Philippines.

3. The capture of potential gains from liberalization of trade in services under the multilateral General Agreement on Trade in Services (GATS).

The following then are a set of preferred policy positions that follow from the Smithian model developed here.

1. Liberalization of Trade for the Producer Services Sector.

The possibility of capturing the productivity gains from an extended division of labor suggests, in general, a strong case for liberalizing trade in producer services. Over and above the static comparative advantages to be obtained, a liberal regime should prove to be especially beneficial to a service-importing country. An increase in the supply of producer services would allow for the adoption of a more complex production structure within the service-importing country. For the service-exporting country, the result may be mixed and depends upon the nature of services exported. If exports increase the price of producer services in the domestic market, it could lead to a reduction in the extent of division of labor.[9] However, if the service industry itself enjoys increasing returns, free trade would reduce service prices in both countries, leading to an overall improvement in the production structure of the trading partners. This would be especially true for services such as banking, transport, telecommunications, and others where economies of scale and scope are known to exist.[10]

The presence of increasing returns either in the producer service sector or the goods sector in the importing country would also dampen the possible "crowding out" effect feared by developing countries (see, for example, Nayyar, 1988; Ryan, 1990) by allowing for increase in the overall size of the market. With generalized increasing returns, liberalization of trade will lead to an increase in total market demand through its effect on productivity and cost (and thus increased supply). Thus, in the face of impending liberalization in the financial and banking sectors, the increased probability or occurrence of mergers and consolidations among existing local firms under production structures of type (D) or (E) indicates an increase in expected total market demand. Concomitant with the market size effect, liberalization makes possible further specialization and thus further productivity gains (e.g., multinational banks will typically specialize in outward transactions and local banks in local transactions).[11]

2. The Limited Gains from Liberalization in the Absence of Division of Labor

Gains from trade in producer services accrue to the importing country from the strong complementarities between these services and economic growth. However, such complementarities emerge only with an extended division of labor. In the absence of an extended division of labor, increased trade in services such as retail would not generate growth. In such circumstances, unambiguous and significant gains from liberalizing these services may not exist. Instead, the policy priority should be to address any existing market or policy induced relative bias against manufacturing or in favor of the nonproducer service sector.

For the Philippines, possible direct and indirect sources of any such bias should be looked into. For example:

> *Direct Sources*: unionization, labor and wage policies, and a relative preference for service employment. These may have raised the actual cost of labor in the manufacturing sector.
>
> *Indirect Sources*: protection, combined with unionization in producer services such as banking, transport, communications, and others. This contrasts with the virtual absence of unionization in sectors such as retail-wholesale trade and tourism (and the informal sector) in developing countries. Protection and unionization may imply higher prices, profits, and wages for these sectors, thus increasing the effective cost of division of labor.

The limited gains from liberalization may be argued for the proposed retail trade liberalization in the Philippines. Traditional gains from liberalization exist if protection has provided extra-normal retail rents, or if the domestic price of retail services are higher than the world price of such services. The labor intensive nature and the minimum capital requirements of retail services in developing countries rule out the latter possibility given the low labor costs prevailing in these countries.[12] Furthermore, a cursory glance at the share of the retail and wholesale sector in the Philippine national output and employment belies the possibility of generalized extra-

normal retail rents for the Philippines. Besides exhibiting the largest output and employment shares in the service sector as a whole, the trade sector boasts of a large number of small firms.[13] Extra-normal retail profits, if any, may be traced to rents earned upstream due to import quotas/tariffs on imported goods or monopoly rents enjoyed by an importer.[14] Thus, for example, in the Philippines expected retail margins would be low on grocery items but high for appliances which enjoy high protection. Therefore, unless protection is withdrawn from the goods sector, retail rents will not be eliminated by the liberalization of retail trade alone. This is not to say that there may not be productivity gains that may accrue from retail liberalization. For example, the inflow of foreign capital into the retail sector could lead to some consolidation of existing firms into larger, more efficient units. The amount of this productivity gain, however, would be limited by the extent of division of labor in the goods-producing sectors. Additionally, by lowering transaction costs retail liberalization can be expected to increase the number of goods available, thus reducing prices. However, the extent and direction of price changes would depend upon the actual composition of the new bundle of goods made available as a result of liberalization.

The trade sector has continued to dominate the service sector output in the Philippines with shares of 34 to 36 percent (at constant prices).[15] And in contrast to the newly industrializing countries, the share of the trade sector in the Philippine GDP (constant prices) increased during the period 1977-1994—this, in spite of the comparatively low growth performance of the Philippine economy in the same period. The relatively high level and direction of growth in the trade sector may therefore imply both the relatively low productivity of this sector as well as a continuing bias toward these services. Without the removal of such biases, liberalization in this sector may not induce significant gains for the economy.

3. On the General Agreement on Trade in Services (GATS).

An important development in the service trade liberalization movement has been the establishment of a multilateral GATS under whose auspices most countries will be expected to develop their respective trade policies (see Broadman, 1994). While a detailed look into the GATS principles and their potentialities for fostering trade

is best saved for another paper, some general perspectives should be offered here. Given the approach adopted in this paper, it should be obvious that the GATS framework of multilateral negotiations is not particularly conducive to a convergence toward rational policy outcomes especially for developing countries (see, for example, Hoekman, 1993, 1995). This conclusion may be traced to two potentially reinforcing sources of irrationality— one exogenous and the other endogenous—in the GATS framework.

First, developing countries may approach the negotiations with an attitude colored by their experience with past and existing trade possibilities (see, for example, Nayyar, 1988): the dominance of developed countries in world service trade; the perceived comparative disadvantage, with a few exceptions, of developing nations in the supply of "high-end" services such as banking, finance, telecommunications; the reluctance of developed countries to include migration of labor services (especially unskilled) from developing countries in the negotiations.

Secondly, when combined with the "give-and-take" nature of multilateral negotiations and the positive-list commitment structure (as opposed to a negative-list) for country-wise liberalization under GATS,[16] these experiences could easily propagate an exclusively sectoral perspective and lead to overlooking the important complementarities between trade in services and growth stressed in this paper.

In addition, member country commitments may discriminate along four modes of exchange in services: cross-border trade, foreign direct investment, consumer movements with respect to location-specific supply, and temporary presence of foreign providers. The problematic of discriminating between the first two supply modes—cross-border trade versus foreign direct investment—are especially relevant to evaluating the potential gains for a service-importing country. The fact that sales of foreign firms established abroad exceed the value of cross-border trade in services reflect a bias, especially in the developing countries, toward the foreign direct investment option grounded in the past economic (or technological) nonfeasibility of cross-border trade (see Moshiriam, 1994). However, continued

adherence to such a bias would deprive the host country of valuable economies that are to be had only through the supplier's international assets and operations. Limiting or disallowing cross-border trade in productive services also reduces the degree of contestability or potential competition in the host-country market, leading to higher prices for these services.

Restrictions on the temporary presence of foreign providers would similarly increase the supply cost of services to a host-country, especially if such providers complement the activities of foreign firms established in the host-country. The presence of potential increasing returns in the host-country, either in the service industry or the goods sector, is also an argument for minimizing the adoption of exemptions violating the market access rule embodied in GATS. Restricting foreign suppliers to export-oriented activities or limiting their size or sales within the local market similarly deprives the host country of important economies, reducing the extent of division of labor and thus the growth gains from liberalization.

NOTES

[1] See, for example, Bhagwati (1984), Samuelson (1964), Balassa (1964), Kravis, *et al.* (1978), Panagariya (1988), Yingfeng Xu (1993), and Summers (1985).

[2] For applications of the theory of comparative advantage in evaluating the gains from trade in services, see, for example, Burgess (1995), Melvin (1989), and Jones and Ruane (1990).

[3] Though each worker-consumer now produces and consumes a greater total quantity (and/or a better quality) of each good.

[4] Though the number of products is assumed to be the same, the effect on growth of the introduction of new products would again be limited by the extent of realizable productivity gains through (B).

[5] With the exception of Thailand where the share of the service sector fell slightly between 1979 and 1994.

[6] The source for Philippine data presented here is the Economics and Statistics Office, National Statistical Coordination Board.

[7] Except during the period 1981-1990 when Indonesia and Singapore recorded higher growth rates in the service sector. Indonesia, however, maintained a higher growth rate in its manufacturing sector even for this period.

[8] The service sector in the Philippines grew from about 35.6 percent of gross national product (GNP) in 1979 to about 43 percent in 1994 (at constant prices). The share of industry, in contrast, has remained more or less steady (with an exception for the decade 1975 - 1984 when it increased to around 39 percent, in current prices, or 40 percent, at constant prices), and in fact showed a slight decrease (about one percentage point) during the 1970-1993 period. More significant was the contraction in the manufacturing sector whose share declined from about 27 percent in 1970 to 24 percent in 1993 (constant prices). The increase in the industry share for the decade 1975-1984 is explained mainly by a spurt in construction activity.

[9] An increase in price of producer services could of course cause local firms to consolidate, as across-market coordination especially under a production structure of type (E) becomes more expensive.

[10] For the presence of economies of scale in banking services and its determination of trade patterns, see Wengel (1995).

[11] For the experience of countries that have liberalized their financial markets, see, for example, Germidis and Machalet (1984), World Bank and UNCTC (1990), and OECD (1991).

[12] See Bhagwati, J. 1984. "Why are Services Cheaper in the Poor Countries," *Economic Journal*, June.

[13] Small firms continue to dominate the market, comprising nearly 93 percent of total registered retailers. See Alonzo *et al.* (1994).

[14] Thus, as noted in the study by Alonzo *et al.* (1994), large stores in the Philippines operate under competitive pressure with fairly tight margins. Margins are higher for small firms which reflect both lower turnover volume and efficiency, as well as location-specific rents.

[15] In 1988, over 60 percent of trade establishments were in the retail business. See National Statistics Office (1989).

[16] The "positive-list" approach refers to a GATS schedule of various services from among which each country may choose a preferred set for purposes of liberalization. Furthermore, with regard to the chosen set, each country can specify exemptions that would violate the non-discrimination principle embodied in three GATS rules: the most favored nation (MFN) rule, the national treatment rule, and a market access obligation.

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APPENDIX

Table 5A.1. Average annual growth rate of real gross domestic product

	1981-90	1989-94
Singapore	6.3	8.5
Indonesia	5.5	7.0
Malaysia	5.2	8.7
Philippines	1.0	2.5
Thailand	7.9	9.5

Source: Asian Development Bank, Key Indicators, 1995.

Table 5A.2. Average growth rate of value added in industry

	1981-90	1989-94
Singapore	5.2	8.8
Indonesia	5.9	8.6
Malaysia	7.4	11.2
Philippines	-0.8	2.4
Thailand	10.4	13.2

Source: Asian Development Bank, 1995.

Table 5A.3. Average growth rate of value added in manufacturing

	1981-93
Singapore	6.7
Indonesia	11.7
Malaysia	10.6
Philippines	0.6
Thailand	10.8

Source: Asian Development Bank, 1995.

Table 5A.4. Average growth rate of value added in services

	1981-90	1989-94
Singapore	7.2	8.3
Indonesia	6.5	7.4
Malaysia	3.9	8.9
Philippines	2.8	3.7
Thailand	7.7	8.5

Source: Asian Development Bank, 1995.

Table 5A.5. Service sector share in gross domestic product (percent shares)

	1980	1994
Singapore	60.1	62.4
Indonesia	37.7	39.8
Malaysia	39.6	39.8
Philippines	35.6	42.8
Thailand	47.6	46.8

Source: Asian Development Bank, 1995.

Table 5A.6. Share in total service sector output (in percent)

Malaysia	1977	1993
Trade	27.0	30.0
Transportation/ Communication	13.0	17.2
Finance	18.0	26.4
Public Administration	29.0	25.5
Others	12.0	0.5

Source: Asian Development Bank, 1995.

Table 5A.7. Share in service sector output (in percent)

Singapore	1977	1994
Trade	33.0	28.0
Transportation/ Communication	17.0	23.0
Finance	31.5	42.0
Public Administration	18.0	7.0
Others		

Source: Asian Development Bank, 1995.

Table 5A.8. Share in service sector output (in percent)

Thailand	1977	1994
Trade	36.0	34.0
Transportation/ Communication	12.6	16.0
Finance	16.0	15.0
Public Administration	10.0	6.0
Others	24.7	28.0

Source: Asian Development Bank, 1995.

Table 5A.9. Share in service sector output (in percent)

Indonesia	1977	1994
Trade	44.0	30.0
Transportation/ Communication	13.0	16.0
Finance	12.4	20.0
Public Administration	21.2	16.0
Others	9.0	7.8

Source: Asian Development Bank, 1995.

Table 5A.10. Trade services share in gross domestic product (in percent)

	1977	1993
Singapore	20.1	17.8
Thailand	17.1	16.3
Indonesia	16.2	16.7
Malaysia	12.4	12.2
Philippines	12.3	15.3

Source: Asian Development Bank, 1995.

COMMENTS

*Gilbert Llanto**

Dr. Nimai M. Mehta calls attention to the link between conventional gains from trade in services and the country's economic productivity, growth and development. There is an obvious reason for this. It does not make sense from the policy perspective to promote trade in services unless there are clear-cut gains in terms of increased economic productivity, growth and development.

By employing Smithian models of specialization and division of labor, Dr. Mehta shows that an understanding of the impact on growth of increased tradeability in services requires a distinction between: (1) producers services (for example, banking, insurance, transport, telecommunications) and (2) final-use services (for example, retail trade, medical care and education). The term "producers services" refers to those services directed toward the "productive" sector while "final-use services" are part of the "nontradeable consumption sector."

Dr. Mehta argues that since producers services have strong complementarities with economic growth, trade in producers services should therefore be liberalized. On the other hand, he asserts that positive complementarities with growth exist only up to a level of minimal provision in the case of final-use services. Since final-use services have minimal or no complementarity with growth, liberalization of trade in these services has a weak case. I can only suggest that such important propositions be supported by a more systematic and empirical investigation.

In Section III of the paper where some empirical evidence is presented, I think there is a misreading of the Philippine data from 1981 to 1984. It is unfortunate that Dr. Mehta chose this period to illustrate his points, for it was arguably an abnormal period. The negative average growth rate experienced by industry and the positive growth rate registered in the service sector reflected the absorption of the unemployed from industry and manufacturing by the service sector during the most severe economic crisis ever to hit the Philippines. These developed as the outcome of a severely debilitating economic crisis and structural imbalances in the economy. During that critical period, political and economic uncertainty led to the

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postponement of investment. An immediate result was the negative growth rate in industry and the exodus of the unemployed to the service sector, specifically to the final-use services like retail trade.

I do agree with the proposition that there is strong case for liberalizing trade in producers services. But I disagree with the assertion that such a case does not exist for final-use services. The absence of or minimal complementarity with growth of final-use services has not been conclusively shown in the paper. I think there is also a case for liberalizing trade in the final-use services. In retail trade, for example, liberalization will promote productivity gains in terms of the entry of more efficient retail firms and the transfer of modern retail technology, as well as welfare gains in terms of greater access by consumers to better quality and competitively priced goods and a decrease in rents being enjoyed at present by big local retailers.

6. Agriculture and Food Security: Protection versus Liberalization (A Panel Discussion)

Cristina C. David
Arsenio M. Balisacan

Cristina C. David

Economists would define food security as having adequate supply of food at affordable prices. The popular view is that food security means being self-sufficient in food. The question is whether or not food security can be achieved more efficiently through a protectionist policy or a liberal trade policy.

I argue that in practice, protectionism is inherently in conflict with the objective of food security. At our level of development, trade liberalization is in fact necessary for the achievement of food security. Where there are high incomes and low prices, protectionism in the sense of restricting imports may be equivalent to self-sufficiency. But protectionism really means high prices. Moreover, since protectionism tends to allocate resources away from areas where we have comparative advantage to areas where we have none, the result is lower growth of output and therefore lower incomes. For this reason, food security cannot be achieved through protectionism. On the other hand, trade liberalization means by definition lower food prices, and with a more efficient allocation of resources, higher incomes. This is the only way to achieve food security.

In general Philippine agriculture, including the food sector, is confronted with both short-term and long-term problems. In the short-term we have experienced sharp increases in the prices of rice, corn, sugar, chicken and others. In the long-term, Philippine agriculture has been characterized by declining competitive advantage since 1980. We can argue that both cases are due to policy failures. The objective of government policy on food prices has been to stabilize prices at levels affordable to consumers and fair to producers. The policy instrument that has been used in the case of rice is a

government trading monopoly on imports and exports of rice. In addition, there are quantitative trade restrictions on corn, sugar and others. The entire agricultural sector is subject to quantitative trade restrictions because of the passage of the Magna Carta for Small Farmers.

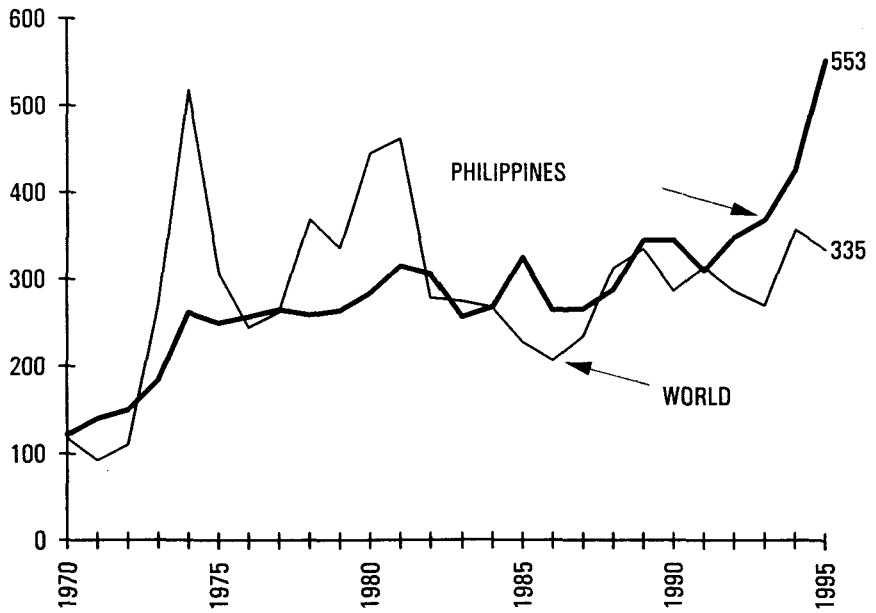
What caused the recent sharp increase in food prices in 1995? I argue that this was due both to the poor implementation or use of the policy instrument as well as the choice of policy instrument. We imported rice too late and we actually imported too little. The government trade monopoly in rice as well as quantitative trade restrictions are also factors which have contributed to the problem. Several incidents since the 1960s have shown that government use of this policy instrument has actually led more to price instability than to stability.

Some sectors have expressed the fear that the membership of the Philippines in the World Trade Organization (WTO) means that we have given up on our objective of food security. But in fact, none of the WTO bindings has actually been implemented in the Philippines. I argue further that, if we actually implemented trade liberalization by allowing private sector participation in rice trading and by substituting tariffs for the quantitative restrictions, then there would not have been major increases in the domestic price of rice and other commodities.

Figure 6.1 clearly shows that the domestic price of rice has generally not only been higher than the world price since the 1980s, but also that the increases in the domestic price of rice have been much sharper. The sharp increase in the price of rice we experienced recently was basically government-made.

We also imported rice too late. Table 6.1 shows the cumulative distribution of rice imports through the third quarter in selected years. During the years when we had significant rice imports, about half of the total imports had come in by the end of July, which is really the beginning of the rainy season. But in July 1995, only four percent came in. Thus, it is clear that rice imports had come in too late. The literature attests that when imported rice comes in too late, or during the harvest months, the drop in farm prices worsens.

Figure 6.1 Trends in domestic and world prices of rice (Index)



Source: Table 6A.1 (see Appendix)

Table 6.1. Cumulative distribution of rice imports from July to October, (selected years)

	JULY	AUG	SEPT	OCT	Total Imports
		(in percent)			(000 metric tons)
1984	43	61	72	92	191
1985	48	64	74	86	540
1988	61	94	100	_	181
1989	28	50	100	_	220
1990	60	74	94	96	622
1993	31	40	74	100	210
1995	4	43	66	100	240

Source: Philippine Institute for Development Studies.

Also in 1995, the seasonal increase of food prices were quite unusual. It was 70 percent for rice (compared to the average of about 10 percent), 23 percent for corn, and 40 percent for sugar. So last year was really quite unusual.

There has been growing protection of rice, corn and sugar over time. Table 6.2 which estimates net protection rates (NPR) indicates that during the 70s rice prices were not protective. The domestic price of rice during the 70s was about equal to if not slightly less than the world price. During the late 80s, the NPR for rice increased somewhat mainly because world prices dropped. But in 1995 it went up sharply to 65 percent. Corn protection increased dramatically, from 26 to 67 percent during the 80s and up to 150 percent in 1995. Sugar has likewise enjoyed high protection since the 1980s.

Historically, Philippine agriculture as a whole has enjoyed minimal protection. But within agriculture, there has been very wide variations in the degree of protection (see Tables 6.2 and 6.3). For exportable commodities (except sugar) there is zero protection, but for importables, protection is quite high. In the early 90s, the NPR for importables was 40 percent which is higher than the average protection for industry and the economy as a whole. Protectionism in agriculture, which is heavily biased against exportables and nontradeables, is definitely distorting the incentive structure within the sector.

We have made real progress in domestic rice production because over time we actually reduced the ratio of imports. (See Table 6.4.) From 1909 to 1939, rice imports were equivalent to 10 percent of domestic production. That ratio has declined over time despite the fact that the population has grown rapidly. In 1995 we imported 240,000 metric tons which is equivalent to 3.3 percent of domestic rice production. Although this is a bit higher than the average, this number is actually low in absolute terms compared to 1990 when we imported more than 600,000 metric tons and 1995 when we imported 540,000 metric tons. Even in the early 70s we imported 400,000 metric tons in one year (1972). So the rice importation in 1995 was not really that large. The same is true for corn imports. The proportion of corn imports relative to domestic production used to be as high as nearly eight percent. Since 1987, that went down.

Table 6.2. Trends in nominal protection rates (NPR*) of major agricultural commodities, 1970-1995 (in percent)

	1970-79	1980-84	1985-89	1990-94	1995
Rice	-4	-13	16	19	65
Corn	24	26	67	76	150
Sugar**	5	42	154	81	104
Coconut products:					
Copra	-17	-28	-6	0	0
Coconut oil	-4	-4	7	18	10
Others	-4	-4	0	0	0
Bananas, pineapple tobacco, abaca	-4	-4	0	0	0
Pork	6	-9	43	31	44
Chicken	34	46	39	74	84

Notes:

* NPR is the percentage difference between the domestic wholesale price and border price converted by the official exchange rate. The border price is the FOB export unit value for exportable products. For importable products, FOB world price is adjusted by 15 percent to arrive at the CIF import unit value. In the case of pork and chicken, the import unit value of Singapore was used.

**The NPR of sugar is the weighted average of the NPRs of sugar exported to the United States and sugar for domestic use. The NPR of U.S.-bound sugar is computed as the ratio of the export unit value to the border price. The NPR of domestic sugar is the ratio of the domestic wholesale price to the border price. Border price is CIF (FOB plus 15 percent).

Source: Philippine Institute for Development Studies.

Table 6.3. Estimated effective protection rates by major sector (in percent)

	Agriculture, Fishery and Forestry	Manufacturing	All Sectors
Tan:			
1974	9.0	44.0	36.0
Medalla *et al.*:			
1983	10.3	79.2	52.8
1985	9.2	74.1	49.3
1986	5.0	61.2	39.8
1988	5.2	55.5	36.3
Manasan (preliminary):			
1993-95	24.4 (28.1)	29.1	26.7
2000	19.1 (25.9)	19.2	18.4

Note: Figures in parentheses refer to crops and livestock only.

Sources:
1. Norma A. Tan (1979) "The Structure of Protection and Resource Flows in the Philippines." In R. M. Bautista *et al. Industrial Promotion Policies in the Philippines.* Makati: Philippine Institute for Development Studies (PIDS).
2. Erlinda Medalla *et al.* (1995) *Catching Up With Asia's Tigers.* Makati: PIDS.
3. Rosario G. Manasan (forthcoming) "Assessment of Tariff Reform in the 1990s."

Government has become more protectionist. We are not competitive in the world market. Importable agricultural commodities, particularly food, are highly protected. I argue that this kind of policy is in fact anti-growth as well as anti-equity. It is anti-growth because it misallocates resources. Corn and sugar are important inputs. Excessive protection of these commodities impedes the growth of agro-

Table 6.4. Trends in rice and corn net imports and sugar exports, 1909-1995 (in metric tons, percent)

	Net rice imports		Net corn imports		Net sugar exports	
	(000 m.t.)	% of prod'n	(000 m.t.)	% of prod'n	(000 m.t.)	% of prod'n
1909-39	119	10.6	N.A.	N.A.	N.A.	N.A.
1946-65	109	5.2	N.A.	N.A.	N.A.	N.A.
1966-76	173	5.1	N.A.	N.A.	N.A.	N.A.
1977-83	(78)	(1.6)	237	7.6	1,275	54.2
1984-89	182	3.2	116	3.0	319	19.8
1990-95	167	2.6	80	1.7	234*	12.7*
1995	240	3.3	135	3.2	N.A.	N.A.

Source: Philippine Institute for Development Studies.

Note:
* 1995 imports not included. Figures in parentheses indicate net exports.
N.A. - not available.

processing industries. For example, corn is an important input in the livestock and poultry industry which accounts for about 20 percent of gross valued added in agriculture. Overprotecting corn and sugar hinders the growth of the food processing sector and consequently induces nominal wage increases. Thus, the competitive advantage of agri-based industries is lowered.

Aside from high levels of protection which distort incentives, the use of quantitative trade restrictions means that the tariff revenues which the government can invest in productivity-enhancing infrastructure are not generated. In the case of rice, what government revenues there should be, go instead to the National Food Administration and are dissipated by their high administrative cost. This is in addition to the profits they get out of imports.

Quantitative trade restrictions are also anti-poor. High food prices affect the poor most because the majority of the poor are net buyers of food. Some rice farmers are poor and corn farmers are poor. The workers in sugar industry are very poor and they are net buyers of food and sugar as well. But they do not really benefit that much from high sugar prices because their wages are determined by labor market conditions, not by the price of sugar.

Now, everyone is saying that because we have joined the WTO things are going to change. We will adopt a more liberal trade environment. Instead of using quantitative trade restrictions, we will shift to tariffication. But we have been exempted from WTO bindings in the case of rice, and so we are going to have the same framework for rice for the next ten years. So the status quo remains in rice. There are changes in other commodities but only in the binding tariffs, i.e., the tariff rate that the WTO allows us to adopt in lieu of quantitative restrictions. But these have not been fully implemented. The Department of Agriculture (DA) has recently taken the stance that we impose 100 percent tariffs in lieu of the quantitative restrictions that will be lifted. But as I have already noted, this kind of policy will lead to increasing protection instead of reducing it. Is this really for the better?

It is said that the Department of Agriculture is pushing for 100 percent tariffs because that is politically popular. We have promised the farmers this. But I argue that the high level of protection being contemplated by DA is in fact politically untenable. Philippine agriculture, compared to agriculture in all other Southeast and South Asian developing countries, has had the poorest performance in terms of the growth rate of gross value added. We also have one of the lowest growth rates of agriculture exports, if not the lowest. In 1992, 1993 and 1994 the growth rate was about two percent and it is now less than one percent. Also, our share of major agricultural exports like coconut products, sugar, bananas and pineapple in the world market has declined over time.

The growth rates of production of rice, corn and sugar are also very disturbing. In the case of sugar production has been declining in absolute terms. Surprisingly, corn production has also been

declining in absolute terms over the past three years when protection increased. Indeed, protectionism does not necessarily mean that we are going to catch up. We have been a little bit better off in rice but nonetheless, this growth rate of 2.2 percent is below the growth rate of the population. This means that in terms of food self-sufficiency, things have not been improving and in fact have been worsening. And I argue that this is mainly due to government's excessive reliance on price and market regulations and too little attention and funding for productivity-enhancing support services.

I know a little bit more about the latter. I say we are not spending enough for agriculture. The problem is not so much that expenditures are relatively low. Rather, expenditures are misallocated, programs are of poor quality, and the implementation of programs is very inefficient due to the organizational structure of the DA bureaucracy and the relatively low competence of bureaucrats particularly at the upper echelons. An examination of the trend in government spending for agriculture would show that agriculture is underprovided relative to the gross value added of agriculture and total government spending, including debt service. This was especially true during the period of economic contraction from the mid-70s through the mid-80s when public spending on agriculture suffered more than the others.

Government expenditures on agriculture do not target productivity and efficiency. Neither are they pro-equity. As we know, DA has devolved most of its operations including extension services to local government units. The DA budget for extension and related services in 1995 was only 1.8 billion pesos. On the other hand, the budget for central administration of the agriculture agencies (DA and the Department of Agrarian Reform) was about 15 billion pesos. The research and development budget provides not only for DA research agencies but also for state universities and colleges specializing in agriculture. The budget for research and development (R & D) is relatively high. But such expenditures are apparently unproductive. Neighboring countries which are outperforming us in agriculture are spending much less on R & D. NFA, which has absolutely nothing to do with productivity, has a budget of 1.6 billion pesos.

Now this is my observation with respect to support services. I think of support services as private goods. Mechanical grain dryers and mechanical threshers are private goods. Why then are cooperatives charged as low as one peso a year for five years for the lease-purchase of mechanical grain dryers? Many cooperatives which have incurred subsidized loans are in arrears. Why subsidize cooperatives which charge market rates for their products and services? Subsidizing farmers' cooperatives is not equivalent to subsidizing farmers. Why distribute high-breed corn seeds for free? Why make it artificially profitable? I am apalled at the prevalence of doleouts in agricultural support programs, not to mention widespread rent-seeking in the form of commissions on purchases of farm inputs and machinery.

As for devolution, the intention was to develop local capability for agricultural support services. But it appears that in spite of devolution the delivery process is still top down. The devolution of personnel to local government units was not accompanied by a real effort to improve local capabilities to deliver extension and related support services. Although government spending on agriculture has recovered since the late 1980s, these expenditures have had little impact on productivity or equity. For example, we subsidize farm mechanization which promotes labor-displacing farm technology. Agriculture projects intended to alleviate poverty are in practice anti-poor.

Arsenio M. Balisacan

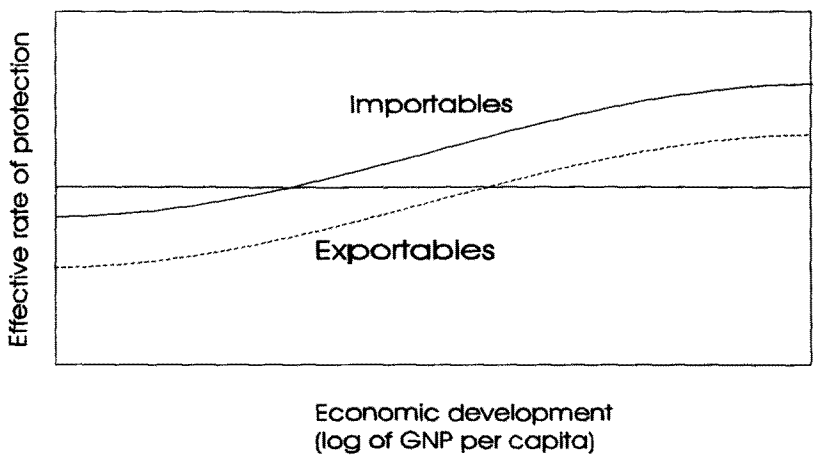
I would like to provide an international and historical perspective to some of the observations made by Dr. Cristina C. David concerning the pattern of protection over time and why the Philippines is now observing high protection. Is this something to be expected at this stage of the country's development? Figure 6.2 shows the pattern of protection of agriculture over time for a cross-section of countries. A number of observations can be made. What you find here is that the level of protection for the importables is typically higher than the level of protection for exportables regardless of the stage of development a country is in. The second observation that we can make is that: for both importables and exportables, a country moves sequentially from penalizing or taxing agriculture to subsidizing agriculture. There is some stage during which the transition from taxing to subsidizing agriculture occurs. This is the case if you look at the cross-section of the countries at different levels of development.

The same is true when you look at the historical evidence about what happens during a long swing. You will find that historically, the pattern has been one of initially taxing agriculture and then subsidizing it except during the Great Depression in the early 1930s. Later on, as development proceeds, the patterns for importables and the pattern for exportables are relatively the same.

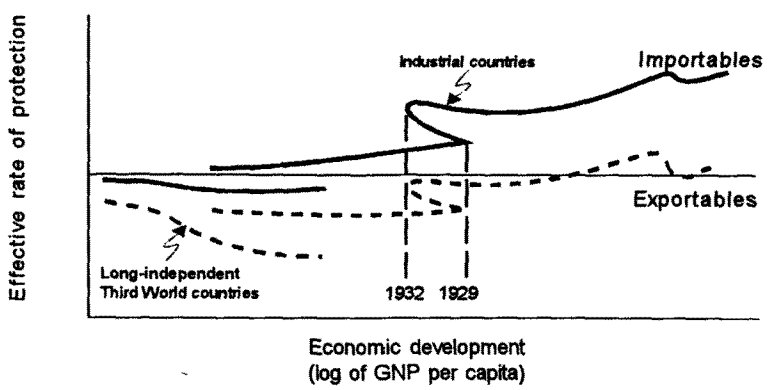
The question that we can ask ourselves is whether or not the Philippine experience is consistent with that of other countries. The experience of South Korea and Taiwan which are relatively young industrialized countries is typical. In the 1950s through the 1960s when both countries were not yet industrialized, agriculture was being taxed by their governments. Only when industrialization took off was there a switch from taxation to subsidization of agriculture. In particular, the price ceiling of staple crops like rice were kept low during the early stages of development and then became very high in the later stages of development. So we ask here: is the Philippines in its present stage of development comparable to South Korea and Taiwan circa the 1950s or perhaps the 1960s? If that were so, then we must be at the stage where agriculture is not yet being subsidized. But according to Dr. David, the level of protection being enjoyed by Philippine agriculture today in fact approximates the level of

Figure 6.2 Summary of global and historical patterns of agricultural protection

(a) The global cross section, 1980



b) Historical paths since the 1860s



Source: Adapted from P.H. Lindert. "Historical Patterns of Agricultural Policy." In C.P. Timmer (ed.). *Agriculture and the State: Growth, Employment and Poverty in Developing Countries* (Ithaca: Cornell University Press, 1991.

protection that exists at present in Taiwan, South Korea and Japan. So why are we jumping ahead of the customary pattern of agricultural protection? There are economic as well as political reasons for this and we might want to ask ourselves what these reasons are.

What explains the high level of protection in the Philippines given our stage of development? Misguided policy is one explanation. But I would like to move back a little bit and try to explain these policies. Policies are not formed out of the blue. There are dynamics of policy formation and these dynamics are partly economic and political in nature. To what extent do political and economic forces intersect? At the early stage of development farmers are relatively not sensitive to food price controls. Why is that? In a typical less developed country (LDC), farmers are at a disadvantage in forming coalitions because of their spatial dispersion and the poor infrastructure in rural areas. This makes it very difficult and costly for farmers to organize.

On the other hand, urban consumers and industrialists have a high stake in a cheap food policy. During the early stages of development, food constitutes a high proportion of the urban consumers' budget so that changes in food prices greatly affect their real incomes. Industrialists favor an agricultural policy keeping the prices of wage goods low to preempt demands for higher wages in labor-intensive industry. So when you look at the balance of power in developing countries what you find is that urban consumers and industrialists tend to be favored by government policy. But as industrialization proceeds you find manufacturing becoming more capital intensive and profit becoming less sensitive to the price of wage goods. Also, the share of food in the urban consumers' budget becomes smaller as incomes increase and therefore the real income of urban consumers begins to be less sensitive to food prices.

Meanwhile, the process of development brings about increasing commercialization and concentration of agriculture, leading to an increase in sensitivity to agricultural prices among farmers. Also, improvements in infrastructure lead to the reduction of the cost of coalition. When you visit a Japanese farm, you will find the Japanese farmer at home with a computer and a fax-modem. With a fax machine and E-mail it is very easy for him to get in touch with other Japanese

farmers and their representatives in the Diet. The clout of the Japanese farm lobby can be inferred from the price of Japanese rice. In Japan during the early 1980s the domestic price of rice was more than 200 percent higher than the world price. This has since gone up. In advanced economies therefore you will find farmers becoming a dominant political force.

There have been some studies documenting the relative influence on policy of domestic interests and it turns out that the dominant influences are really economic in nature. In the Philippines a few studies conducted along this line reveal that indeed economic forces are a substantial part of the story of rising protectionism over time. We pose the question again: is the Philippines an exception to the trend? Dr. David's data show that we are ahead of what is expected given our stage of development. We are forming our agricultural policy as if we were already a Taiwan or South Korea or Japan. But the fact is, protectionism will arguably rise if the dynamics that we outlined above hold true.

APPENDIX

Table 6A.1. Trends in rice domestic and border* prices (Index)

	Domestic	World
1970	122	118
1971	140	92
1972	150	110
1973	184	270
1974	262	518
1975	250	309
1976	257	245
1977	265	262
1978	259	369
1979	264	336
1980	284	445
1981	315	462
1982	306	279
1983	257	275
1984	268	268
1985	325	228
1986	265	207
1987	266	235
1988	288	313
1989	345	335
1990	345	287
1991	310	314
1992	349	287
1993	369	270
1994	426	357
1995	553	335

Note: * FOB + 15%

Source: Philippine Institute for Development Studies.

Table 6A.2. Trends in imports/exports tonnage and ratios of imports/exports to domestic production for rice, corn, and sugar, 1970-1995

	Rice		Corn		Sugar			
	Net Imports		Imports		Imports		Exports	
	000 mt	% of prod'n	000 mt	% of prod'n	000 mt	% of prod'n	000 mt	% of prod'n
1970	-2	-0.1	1	...	0	0	1,225	65.0
1971	379	11.1	55	2.7	0	0	141	7.3
1972	451	13.6	160	7.5	0	0	1,224	59.5
1973	308	8.8	7	...	0	0	1,589	64.4
1974	165	4.6	16	0.6	0	0	950	42.9
1975	147	3.5	16	0.6	0	0	1,074	36.8
1976	55	1.3	12	...	0	0	2,149	80.1
1977	-15	-0.3	148	5.2	0	0	1,590	66.1
1978	-47	-1	105	3.7	0	0	998	43.6
1979	-127	-2.5	35	1.2	0	0	1,619	71.5
1980	-231	-4.6	250	8.2	0	0	1,541	66.5
1981	-83	-1.6	253	7.7	0	0	1,106	45.7
1982	0	0	341	10.0	0	0	1,214	49.3
1983	-40	-0.8	528	16.9	0	0	861	36.9
1984	190	3.7	182	5.6	0	0	877	51.0
1985	541	9.5	281	7.3	0	0	278	18.3
1986	0	0	...	...	0	0	156	11.7
1987	0	0	56	1.3	44	3.2	146	10.5
1988	151	2.7	25	0.6	59	3.7	181	11.4
1989	209	3.4	154	3.4	59	0	275	15.7
1990	593	9.8	343	7.1	0	0	312	18.1
1991	-10	-0.2	...	...	0	0	172	8.6
1992	-30	-0.5	...	...	0	0	265	12.9
1993	210	3.4	...	....	0	0	272	15.0
1994	0	0	...	...	53	32	150	9.1
1995	240	3.4	135	3.2	N.A.	N.A.	N.A.	N.A.

Source: Philippine Institute for Development Studies

mt - metric tons
NA - not available

7. Labor Standards in Open Economies and the Social Clause

Emmanuel F. Esguerra

INTRODUCTION

The progressive globalization of markets and production systems presents both new opportunities as well as risks for workers around the world. On the one hand, the greater openness of countries to international trade and investments means an expansion in employment and incomes consequent upon the growth of production to serve an enlarged market. On the other hand, the increased competition from imports and for export markets and the relative ease with which capital can shift locations in search of the highest returns greatly imperil jobs, wages and social security in those countries that fail or are slow to adapt to the changing economic environment.

With the greater trade and investment flows between developed and developing countries, labor markets are becoming closely integrated, increasing the scope for substitution between domestic and foreign labor in these countries in response to differences in the terms at which labor services can be obtained. This development has raised fears that the low wages and lax labor standards in third world countries will depress wages or increase unemployment in the first world. At the same time, workers in the once heavily protected sectors of developing countries dread the loss of their jobs and the further deterioration of their pay and working conditions as import competition intensifies and as their governments compete with one another to attract or retain foreign capital.

The view that global competition may result in a worsening of employment conditions has rekindled interest in the idea of linking international trade with labor standards. Though about a century old (Servais, 1989), the idea is certainly not dead as recent events have shown. During the negotiations in the Uruguay Round of the General Agreement on Tariffs and Trade (GATT), some governments

of industrialized countries along with the International Confederation of Free Trade Unions (ICFTU) advocated the inclusion of a **social clause** in the multilateral trade agreement. The motivation behind a social clause is to exact compliance with a set of minimum labor standards by restricting trade with countries (or industries or firms in those countries) which are found to be violating such standards. In the process, export producers are being forced to choose between improving the terms of employment of their laborers and losing their export markets.

Advocates for labor rights in developing countries almost invariably find the idea of a social clause in the world trade agreement attractive,[1] but their governments have rejected the proposal, claiming erosion of their competitive advantage and protectionism on the part of high-wage economies. Proponents of the social clause counter that the social clause seeks to standardize neither wages nor health and safety standards across countries but only to guarantee that labor is allowed the exercise of its basic rights (i.e., freedom of association, right to self-organization and collective bargaining, and freedom from forced labor, child labor and discrimination) as provided for in the various International Labor Organization (ILO) Conventions. As matters stand, no consensus has been reached although the issue will be re-opened in the World Trade Organization (WTO).

This paper discusses two issues that have taken center stage in the social clause debate. The first concerns the more proximate question of linking labor standards with international trade. The second relates to the more fundamental issue regarding the value of labor market interventions; in particular, whether there is a case for minimum labor standards. This paper surveys the existing literature in order to provide an informed perspective regarding the issues surrounding the social clause. Section I discusses the conventional economic view of labor standards and shows why the market will generally underprovide labor standards. Section II focuses on the social clause debate and examines the arguments that have been put forth both in support of and against a social clause as the means of enforcing labor standards internationally. Section III deals with some practical questions that have been raised about the social clause, and argues that any gain for Philippine labor will be marginal at best and contingent on the effectiveness of domestic monitoring and enforcement. Section IV summarizes and concludes the paper.

I THE ECONOMIC RATIONALE FOR LABOR STANDARDS

Labor standards are the rules that provide for minimum conditions of employment.[2] These minimum conditions generally fall under two categories depending upon what they seek to accomplish. Labor standards aim either to **promote opportunities** for workers to improve their situation in their place of employment, or to **realize certain desirable social outcomes** such as redistribution, or minimum basic needs. Examples of labor standards under the first category are legal guarantees against forced labor and various forms of discrimination, and workers' rights to organize, seek redress, bargain collectively with employers, and strike. Examples of standards under the second category include minimum wages, regular hours of work, occupational health and safety, and prohibitions against child labor.

The worker's interest in minimum labor standards—apart from the wage—derives from the nature of an employment contract, which is differentiated from an ordinary sales contract by the authority relation existing between a worker and an employer (Simon, 1951). In an employment contract, the worker agrees to place his labor power at the disposal of an employer in exchange for a wage and other benefits for an extended period of time. Since the contract can specify only certain aspects of the worker's actions while leaving the rest to be determined by the employer—i.e., the employment contract is "incomplete"[3]—it matters to the worker that the range of his actions that are left to the discretion of the employer lies within his acceptance region. By specifying what the employer is not allowed to do as well as the circumstances under which the employer may require the worker to perform some previously unspecified tasks, minimum labor standards forestall the possibility of opportunistic actions by employers owing to the incompleteness of the employment contract.[4]

The rationale for legally mandated labor standards, particularly those relating to workers' rights, can be understood by considering what the situation would be like without them. The view inherited from neoclassical economics is premised on a labor market where the conditions of employment desired by workers can be achieved through a competitive process without need of state intervention. According to this view, workers express their preference for working conditions through their choice of employer, while employers are

induced by competition to supply the conditions of work desired by workers. At equilibrium, no more than the socially necessary level of labor standards will obtain.

The market determines the optimal level of labor standards in this way. Suppose that an employer's offer consists of a package that includes a wage and a non-wage component,[5] where the latter specifies the conditions of work (e.g., workers' rights, safety-at-work, non-wage benefits). In this formulation, an improvement in the conditions of work is denoted by an increase in the non-wage component. Suppose that workers will supply their labor services only to those employers whose non-wage offers meet their minimum desired conditions of work so that firms unwilling to employ workers on these terms will find themselves unable to hire any worker. Suppose further that, because increasing the non-wage component increases labor cost, any increase in the non-wage component must be compensated by a decrease in the wage rate offered by the employer to keep labor cost (and employment) the same. Then, if workers chose their employers on the basis of both the wage and non-wage components of their employment contract, in equilibrium only those labor standards actually chosen by workers and provided by the employers would be observed.

More generally, in the presence of many firms offering various combinations of wage and non-wage benefits and workers with varying marginal rates of substitution between wages and non-wage benefits, a self-selection process will lead workers to be employed in those firms with the compensation package closest to what they desire. According to this line of argument, workers will obtain the conditions of employment they prefer without any need for state intervention. Any mismatch between employers' offers and workers' preferences can be corrected through the competitive process, with workers adjusting their non-wage demands and employers their offers.

Labor markets do not function in the way of competitive markets to yield socially optimal outcomes with respect to conditions of work (Edwards, 1993). Competitive markets assume perfect knowledge on

the part of economic agents with respect to the price and quality of what is being traded. When information is unequally distributed, however, bargaining cannot be expected to yield efficient outcomes.

The asymmetry of information at the job search stage between employer and worker leaves the latter at a disadvantage in the bargaining process. Employers have no incentive to fully reveal to job applicants information about working conditions and workers' rights within the firm.[6] Such information becomes known typically only when the worker has already been hired. Thus, no real comparison across employers is possible for job seekers, contrary to what the standard competitive model postulates.

But if a worker feels that he has been deceived about work conditions, he can always terminate or "exit" from the employment relation. Using Hirschman's exit-voice framework, Freeman (1976) analyzed worker quits as a form of exit-behavior corresponding to the free market mechanism for signalling to employers workers' preferences for conditions of employment, remuneration packages and workplace rules. The problem with this option is that it is a very costly way of registering worker preferences (Edwards, 1993). The costs of job mobility for incumbent workers are often great, involving loss of specific human capital, benefits (e.g., retirement pay) tied to the present employer, costs of relocation, disruption and risk of loss of current income, and the personal inconvenience of dislocating and uprooting oneself and family. These costs, especially in periods of tight labor markets, make job quits ineffective in compelling employers to renegotiate employment contracts with workers.[7]

More fundamentally, the bargaining view of standards setting is inadequate because it ignores the basic inequality between worker and employer with respect to their bargaining positions. This inequality stems from the qualitative difference between the worker's and the employer's disagreement payoffs. Failing to get a job or losing one has severe personal consequences for a worker; it can mean loss of subsistence, deferment of a child's schooling, postponement of house rental payments, or going into debt. In contrast, except in very rare situations an employer can afford to be indifferent to hires, fires and quits.

The lack of credibility of the threat of exit on account of its often prohibitive cost for the worker makes the exercise of "voice" the only feasible alternative for seeking improvement in the conditions of employment. However, even the voice option may fail to produce the optimal level of labor standards in a market setting characterized by individual bargaining. There are two reasons for this. One is that, sans legal guarantees, the prospect of facing reprisals from employers can deter the exercise of voice. The reasons described above that render the exit threat ineffectual also tend to stifle voice. Labor unions and collective bargaining find their raison d'etre precisely in the need to strengthen voice in the labor market. The workers' collective voice, which can also be exercised in the form of a temporary collective exit (strike),[8] is a countervailing force against the authority of the employer which can be used to intimidate or retaliate against individual workers who express discontent.

The second reason has to do with the nature of most labor standards and the way they are supplied which invalidate the approach that relies on the market mechanism to determine their optimal level. In many cases, the cost of providing workers' claims can be substantially reduced for the employer if these are provided in a standardized package rather than as separate and individualized items subject to individual bargaining. Imagine the transactions cost of negotiating, providing, administering and enforcing different rules per worker with respect to hours of work (e.g., rest periods, coffee and lunch breaks, vacation and sick leaves). Economies of scale at the firm level explain why safety-at-work conditions and grievance resolution procedures, among others, are not matters for individual bargaining even if they are critical elements affecting the conditions of work.[9] More often than not, these are unilaterally determined by employers.

The problem is that conditions of employment determined unilaterally by employers lack enforceability. Since such conditions are independently installed by the employer —i.e., they are not the outcome of bargaining—the possibility remains that they can be withdrawn at any time by invoking the employer's prerogative (Edwards 1993). By bargaining and reaching an agreement with

employers about work conditions and workers' rights, labor unions not only provide employers information about workers' preferences but, more importantly, help ensure the enforceability of agreements.

Moreover, labor standards pertaining to a number of workers' claims possess the properties of non-rivalness and non-exclusion. One worker's benefit from working in a safe and healthy environment, or in one that is free from discrimination, does not deny his co-workers the same. Once available, workplace safety and health standards and non-discrimination policies cannot be applied selectively. In the case of job safety and other factory conditions, exclusion is not only infeasible but also inefficient. In the case of non-discrimination, selective application would violate a socially acknowledged norm and may invite public criticism. The public good properties of most labor standards imply, however, that they are susceptible to the free rider problem and will likely be underprovided if their production is left to be determined by individual bargaining.[10] This strengthens the case for workers' unions and collective bargaining.

Without the benefit of legal protection, however, the ability of workers to organize and bargain collectively with employers to promote their welfare can be considerably weakened as employers can engage in various actions to discourage, prevent, undermine or destroy labor unions. This makes state guarantees on the workers' right to form associations and engage in collective action a necessary condition for attaining the conditions required for free competitive markets. Without this legal guarantee, workers will be denied an effective voice in the workplace.

Without any mechanism for exercising labor's voice, labor standards will tend to be sub-optimally provided. But why should society as a whole have any business in the provision of labor standards? What does it stand to gain by intervening in the affairs of workers and employers?

To answer this question, it is necessary to return to the nature of the employment contract. Suppose that workers are dissatisfied with conditions of employment in their factory but have no way of

venting their grievances or talking things over with their employers. Recall that while the residual authority to decide on the use of a worker's labor power (during the time contracted for) rests with the employer, control over the exercise of his labor power remains with the individual worker. This situation gives the worker the flexibility to respond in any number of ways. The individual worker may of course choose to terminate the employment relationship at any time, although as noted above this option can be costly. Or he may choose to partially withhold his labor power—by exerting less effort (shirking), engaging in slowdowns, working effectively shorter hours (e.g.,absenteeism, taking long or frequent breaks), or engaging in "quiet sabotage" (e.g., deliberately producing substandard products to destroy the employer's reputation)—in response to actions by the employer that are deemed unacceptable.

The absence of clear rules regarding the handling and settlement of industrial relations disputes (which labor standards seek to provide) can be costly for employer and worker alike. Anticipating how workers will act, the employer will now respond by instituting stricter measures to closely monitor the actions of employees, while the latter will try to find new ways to avoid "getting caught." In the extreme case, job quits will increase and employers, faced with high turnover rates, will tend to invest less in industry-specific human capital formation. All these mean that productive resources (the employer's money and the workers' time and energies) better spent otherwise are dissipated in efforts to protect each side's interest (the employer his profits, the worker his well-being).

On the other hand, in the presence of well-defined rules governing industrial relations, disagreements between employers and workers can be settled at the bargaining table to the mutual satisfaction and gain of both parties. The legal guarantee on the workers' right to strike provides workers with another avenue for pursuing their demands on management just as it informs employers about the possible costs and benefits of not reaching an earlier settlement. This is not to suggest that the problems arising from the incompleteness of the employment contract have been solved, but only to note that the institution of clear and definite rules about how both transacting parties should behave establishes in the labor market what Nobel laureate Douglas North (1990) refers to as a

"stable structure to human interactions" (p. 6). By limiting and defining the choices available to labor market participants, labor standards reduce the uncertainty involved in social interaction, thereby preventing labor market transactions from becoming too costly and making it possible for productivity gains to be realized.[11]

To the extent that nations value the productivity gains implied by having a stable industrial relations climate, they will have an interest in maintaining minimum labor standards quite independently of the level and mix prevailing in other countries.

II. THE SOCIAL CLAUSE DEBATE

In open economies, trade flows and factor movements respond to differences in labor market characteristics across countries. Labor standards thus occupy a prominent place in current discussions about international economic integration. An entire volume (Sengenberger and Campbell, 1994) to commemorate the 75th anniversary of the International Labor Organization (ILO) is devoted to the subject of economic interdependence and labor standards. The recurrent theme in many of the contributions to this volume is the tension between production systems and labor markets which have increasingly taken on a global character, on the one hand, and labor market policies and institutions which have remained essentially national in scope, on the other. The Brookings Institution Project on Integrating National Economies has also devoted one of its twenty-one volumes (see Ehrenberg, 1994) to an examination of the pressures imposed by globalization on labor market policies within politically sovereign nations, and the potential for such policies to either hasten or hinder economic integration.

The debate on the social clause concerns essentially the same question raised in the previous section, albeit at the level of the international economy: if national economies, in order to take advantage of the gains from cooperation, find it in their interest to maintain minimum labor standards, should not the same logic apply on a world scale in order to fully exploit the benefits from integration? In other words, does the dismantling of economic barriers among

countries require that labor market policies within nations also coincide? Will a social clause be an effective mechanism for achieving the benefits promised by globalization?

The declared aim of a social clause is to ensure that workers from exporting countries are not made to work under harsh or exploitative conditions and that industries in the importing countries—and their workers—are protected from unfair competition. By using the threat of restrictions on trade or capital flows to exact compliance with labor standards, the social clause is essentially an instrument of coercive action. In the context of existing proposals to incorporate it in the WTO, it is an institutionalized form of international pressure on governments to conform to a set of labor standards determined to be universally applicable.

To date the inclusion of a social clause has been limited to a number of international commodity agreements such as those on sugar, rubber and tin and in the case of the United States (US) since 1983, to at least four laws (the Carribean Basin Initiative, the Overseas Private Investment Corporation, the Generalized System of Preferences, and the 1988 Omnibus Trade and Competitiveness Act) that link its trade and investment policies to respect for international labor rights (Servais 1989; van Liemt 1989). The provisions in the commodity agreements generally refer to the observance of "fair labor standards" and improving the living standards of workers. Yet, as van Liemt (1989) has found, they have been no more than mere statements of intention, with no particulars on the matter of the standards or the regulations themselves, what constitutes a violation, who the deciding authority is, what the mechanisms for verification are, and what the sanctions are. An exception seems to be the bilateral agreement between Migros, a Swiss retail cooperative, and Del Monte, its supplier of Philippine pineapples, where at least a concrete basis for verification is specified.[12] With the US laws, opinions vary regarding their impact on labor conditions although weak monitoring of violations, difficulty in interpretation, and arbitrary application of the laws seem common.

The need for a social clause, according to its proponents, arises from differences in standards across countries which allow the country with lower standards to "export its products at lower prices

and thus acquire an unfair advantage over its competitors" (Servais 1989). By insisting that the exporting country observe minimum labor standards, the importing country is able to protect its industries to the extent that higher labor standards raise the costs of exporters. Of course, workers in the exporting country also stand to benefit from the better conditions of employment, but not before firm owners adjust to the higher costs, which could mean unemployment for some of them.

The thinking behind the social clause finds a historical antecedent in the so-called pauper-labor argument for protection (cf. Lal 1981) which contends that imports produced with low-wage labor harm importing countries which should, therefore, impose tariffs against low-wage imported goods as a measure of protection for their domestic industries. This argument was quickly disposed of in 1930 by Haberler in his book *Theory of International Trade*, where he called it a "stupid idea" whose application would "destroy all international trade, since this arises only because of differences in costs" (as cited in Lal 1981).

Comparative advantage is the basis of international trade. Developing countries enjoy a comparative advantage in labor because this factor is relatively abundant in these countries, causing wage rates to be lower than in developed countries. In addition, because of their initially low level of income and economic development, the demand for labor standards in these countries is also low.[13] Imposing higher labor standards than warranted in these countries will only increase their labor costs and cause them to lose their comparative advantage. The social clause thus ends up penalizing the very same people it wants to help. To the extent that countries raise their labor standards as incomes rise, the social clause only makes it more difficult for them to do so by restricting their trade opportunities.

The tariff-like nature of a social clause as well as the governments that make up its constituency have made its critics view it as a form of "disguised protectionism" against developing countries. The official position of the Association of Southeast Asian Nations (ASEAN), which the Philippine government shares, reflects this view. A 1992 Joint Communique from the ASEAN Labor

Ministers "reiterated their grave concern over the increasing attempts to impose pressures on developing countries to comply with rigid ILO standards and to link such compliance with international trade privileges" (ILS, 1996). Furthermore, the ASEAN Labor Ministers urged the ILO to review its labor standards, taking into consideration the economic disparities between developed and developing countries.

Despite the seeming cogency of the disguised protectionism argument against a social clause, Krueger (1996) found "surprisingly little empirical evidence—one way or the other—on the issue" (p. 13). Following the argument that legislators support international labor standards in order to protect domestic interests, Krueger proceeded to examine whether support for specific labor standards legislation is greatest among legislators whose constituents stand to benefit most from them. Specifically, he studied the determinants of support for the proposed Child Labor Deterrence Act of 1995 which, if passed, would prohibit the importation to the US of goods produced abroad with child labor. The probability that a member of the US House of Representatives is a cosponsor of the bill was related to the characteristics of the representative's district and his political background. Theoretically, because imported products produced with child labor and products made in the US by less-educated workers are competing products, constituents with low educational backgrounds and their employers are the direct beneficiaries of the proposed bill if passed. Then if support for the anti-child labor bill is protectionism in disguise, one should observe strong support for the bill among legislators from districts with relatively many high school dropouts.

Krueger's econometric results fail to support the disguised protectionism argument against a social clause. He also observed that representatives from districts that have a higher union rate are more likely to support the bill, but because union labor and child labor are unlikely competitors, disguised protectionism is not a plausible explanation. However, upon relating support for the North American Free Trade Area (NAFTA) and GATT with support for the Child Labor Deterrence Act, the study revealed that those who had opposed expanding trade opportunities through NAFTA and GATT were also more likely to support the Child Labor Deterrence Act. "This finding suggests that those who support international labor

standards are more likely to favour protectionist policies generally, but the findings for the education variable make it unclear whether those protectionist policies are in the narrow interest of their constituents" (Krueger, 1996, p.15).

Although Krueger did not test for it directly, the education variable result (that representatives with constituencies that stand to benefit most from the bill are **least** likely to co-sponsor it) appears to be more consistent with Freeman's view (1994) that child labor standards is a normal good (whose demand rises with income). Thus people with a higher socioeconomic status (as measured by educational attainment) are inclined to choose representatives who are more sympathetic to restricting the practice of child labor. Krueger admits to the possibility that support for other types of labor standards may well mask protectionism but is unwilling to concede the point at least as regards the Child Labor Deterrence Act. On balance the disguised protectionism argument against the social clause is not conclusive.

Interestingly, the resurgence of protectionism is an argument being used by critics and advocates of the social clause alike. The social clause is needed, according to its supporters, precisely because it would be difficult to resist the resurgence of protectionism without it. What is interesting about this argument is that it claims the social clause to be the exact opposite of what its critics make it out to be. The anti-protectionist argument for the social clause is based on the view that there is already a protectionist revival in the advanced countries in response to the threat of lower wages and job losses arising from the flood of cheap third world exports. This protectionist revival has found expression in accusations of "social dumping" and arbitrarily imposed restrictions on the entry of developing country exports. In this scenario, third world workers and exporters alike will be better off where the minimum standards to be observed are agreed upon and the mechanisms for verification and dispute resolution are well-defined rather than ad hoc. According to the ICFTU, a social clause will "strengthen the political authority of the WTO and thus the multilateral framework for open world trade. It will create a mechanism for resolving disputes which, if left unresolved, would increase pressures for protectionism" (ICFTU,

1995). Furthermore, the ICFTU asserts, "Far from being a new barrier to trade, a social clause would serve to protect the access of developing countries to world export markets."

Accepting the basis of this argument to be true, it is nevertheless still possible for developing countries to seek relief from arbitrarily imposed barriers within WTO rules without introducing the complications that a social clause might create. Within the GATT, there are remedial measures that are open to developing countries ranging from direct consultations with the country imposing the trade barriers to filing a formal complaint with the WTO, which under the new rules is expected to be more expeditious and less political in the settlement of disputes (Sereno, 1995).

A social clause within the WTO framework has also been justified as a means for avoiding destructive competition or "a race to the bottom" which advocates argue will lead to a deterioration in the working and living conditions of workers and consequently decreased trade. Langille (1994) uses the familiar prisoner's dilemma to drive home the point. Given two countries with identical labor policies both seeking to attract capital investment to create jobs and produce other benefits, capital will choose that country with the lower labor standards (regulatory price). If the two countries could agree to cooperate and not reduce labor standards, they would both be better off. But the potential to increase one's benefit through a reduction of labor standards, regardless of what the other one does, creates an incentive for each country not to cooperate, leading to a lower level of labor standards in both countries with no net impact on investment. The point is that in the absence of a mechanism for achieving cooperation, both countries will rationally engage in strategic behavior leading to the least desirable result. Marshall (1994) argues that "in a more competitive global economy, failure to adopt enforceable standards will, by default, allow countries that permit companies to exploit their workers to impose their standards on others" (p. 72).[14]

At the margin, low labor standards in one country exert a downward pressure on standards in other countries in an integrated global trading system. It does not seem plausible, however, that competitive forces will deliver a common, negligible set of labor

standards for all countries. Each country still ultimately chooses its own set of standards depending upon its attitude toward the trade-offs involved. For example, if labor standards increase labor costs, each country will choose higher or lower standards depending upon which policy goal—employment creation or better employment conditions—has a higher social valuation.

Ehrenberg (1994) cites the fifty state economies of the US as an example of an integrated economy, i.e., with goods and services allowed to flow freely across state boundaries. Yet within this integrated economy, each of the states has its own set of protective labor legislation and social insurance co-existing with that of the federal system. The fact that benefit levels do not converge across states over time indicates that the states differ in their social welfare functions. Some states place a higher value than others on worker welfare and are willing to incur the costs (e.g., higher taxes, higher consumer prices, higher costs for businesses) attendant to providing a higher standard of living for workers. Thus, Ehrenberg concludes that harmonizing labor market standards among countries is not necessary for economic integration at the international level.

In open economies with different national currencies and flexible exchange rates, a particular country's choice need not be limited to either higher labor standards or a higher rate of employment growth (to the extent that the higher cost of labor erodes competitiveness).[15] In general, a country can "purchase" the level of labor standards it wants in three ways: through a currency devaluation, through lower wages, or through general taxes (Freeman 1994). In the first case consumers pay in terms of higher prices, while in the second case workers pay for the benefits they receive.

Overall, the "race to the bottom" argument for a social clause is not persuasive simply because there are sufficiently powerful forces at work within individual nation-states that will frustrate such a scenario. As countries benefit from the effects of globalization the demand for labor standards among their populations is bound to rise. Experience shows a close association between higher labor standards and higher levels of income and economic development. Within individual nations, moreover, the political acceptability and social legitimacy of policies associated with opening up the economy

may require adjusting labor standards to ensure that the benefits from freer trade are equitably shared. This pressure on national governments acts as a brake against the tendency to ignore equity for the sake of growth.

III. SOME PRACTICAL QUESTIONS CONCERNING THE SOCIAL CLAUSE

Regardless of the position that one takes on the issue, there are some practical impediments to the implementation of a social clause that cannot be glossed over.[16]

First of all, there is the issue of which standards ought to be included. This goes back to the distinction between so-called basic or core standards which labor supporters view as constituting human rights and therefore must be universally guaranteed, and those labor standards which are a function of the level of a country's economic development. So far, the consensus has been to include only the basic standards which are defined in various ILO Conventions and contained as well in the International Bill of Rights. These are: (i) the freedom of association (ILO Convention 87); (ii) right to self-organization and collective bargaining (ILO Convention 98); (iii) freedom from forced labor (ILO Convention 105); (iv) freedom from child labor (ILO Convention 138); and (v) freedom from discrimination (ILO Conventions 111 and 100)

One problem with using the standards as defined in the various ILO Conventions is that these conventions may not have been ratified by the developed countries. For instance, the United States, a prime mover behind the social clause, is not a signatory except to the convention against forced labor. Using these standards in formulating social clauses in trade agreements with developed countries therefore exposes the possibility that the standards themselves may not be acceptable to all.

Even after narrowing the standards down to the basic ones, the problem of defining what constitutes a violation still remains in light of the different conditions prevailing in different countries. For

instance, it is well-known that in less developed agrarian societies children as young as ten years old are engaged in farm labor, a form of employment that is certainly far from what is referred to as "exploitative." Proscribing all forms of child labor would ignore the specific characteristics of and special circumstances prevailing in many less developed countries. However, a flexible application of labor standards to account for all possible economic, social or cultural differences among countries makes verification of compliance difficult and costly.

Incentives for compliance will also most likely differ across countries based on their size and importance in international economic transactions. Small countries that are heavily dependent on international trade or foreign investments for their growth but are unimportant sources of imports for the rest of the world, have a greater inducement to comply because of the high cost of non-compliance for them. Penalizing these countries also imposes no significant costs by way of economic disruption on the rest of the trading world. The situation is quite different when the violators happen to be the bigger and developed countries. In this instance, restricting trade with developed countries can hurt the "offended" rest-of-the-world more than the offender, thus weakening the incentive to penalize the latter. This makes compliance very difficult to enforce on an equal treatment basis.

Studies cited by Ehrenberg (1994) suggest significant non-compliance with labor standards in the United States, one of the major advocates of social clauses. The labor standards violated include minimum wage, overtime hours, child labor, and occupational safety and health legislation. In one study the extent of violation of labor laws governing collective bargaining was also noted to have increased over the last thirty years in the United States. Non-compliance has been traced to the lack of resources for monitoring observance and enforcement of labor standards, and the low penalties meted out to first-time offenders.

Labor unions find the idea of a social clause attractive because they see it as an added measure of protection against domestic policies that violate the rights of labor. If governments are committed

internationally to complying with certain minimum labor standards, this tends to overcome organized labor's weak bargaining position *vis-á-vis* employers. The state is compelled to make employers observe such standards or suffer the consequences.

Labor's bargaining position is strengthened, however, only where the sanctions apply, i.e., in export-oriented industries. As such, an effective social clause unintentionally protects only those who probably least need the protection. This would be the workers in the formal, export-oriented sectors, whereas it is common knowledge that many developing countries still have a sizeable informal sector employing the majority of the labor force. Workers in the informal sector who are largely unorganized therefore have little to benefit from the social clause. This is not an argument against the social clause per se; but to the extent that labor organizing is a function of the "cost" of organizing (which includes not only resources but also the effort involved), and a social clause lowers this cost, then a social clause would only reinforce the already existing bias in labor organizing in favor of the formal, urban sector. As a result, the gap between workers in the export and nonexport sectors may widen.

The position of organized labor in the Philippines has thus far been to support the proposed social clause. It is interesting that all the standards proposed for inclusion in the social clause are already guaranteed under the Philippine Constitution. Apparently, the position of organized labor is that these standards are not being enforced and that there is a need for an international watchdog if only to ensure that the government complies with its own standards. As an indication of the extent of violation of constitutionally-mandated labor standards, a recent study (Aldaba 1996) reveals that the majority of strikes in the Philippines (62 percent based on data for the period 1987-93) are caused by unfair labor practices. These involve "any act of infringement on the right of workers to self-organization, free collective bargaining and concerted activities as enumerated" in the Philippine Labor Code (Aldaba 1996).

Questions about which international body should oversee compliance with labor standards and the procedures for filing complaints and resolving disputes are discussed in van Liemt (1989) and Servais (1989), among others.[17] Given the amount of monitoring

work entailed in the implementation of a social clause, it is next to impossible for an international central body to be able to perform this task. This implies that domestic efforts will ultimately provide the basis for monitoring and reporting violations of international labor standards. In many cases, however, the existing government machinery may not be up to the task. Problems of budget, qualified personnel and the appropriate incentives typically hound labor departments. Then there is also the sheer difficulty of monitoring itself, a task made much more problematic by the recent trend toward decentralized production (subcontracting). These considerations suggest that labor organizations and their supporters have a role to play in ensuring compliance with labor standards. Studies have shown that there is a positive association between union presence in firms and the occurrence of more zealous inspections for compliance with labor standards (as cited in World Bank 1995).

What does a social clause then imply for Philippine labor? Based on the foregoing, it is apparent that the degree to which a social clause will benefit the labor sector also depends on labor's efforts. This means that attention should be directed at building and strengthening the capacity of the labor sector to monitor and report compliance with labor standards. These are precisely activities that the labor sector ought to do even without a social clause. If, however, organized labor in the Philippines cannot perform these tasks effectively in connection with labor standards already guaranteed under the Philippine Constitution, then it would be expecting too much of an international agreement to think that it can compensate for labor's weak bargaining position.

IV. SUMMARY AND CONCLUSION

The linking of labor standards to international trade has been advocated as a response to the prospect of worsening labor conditions in the present era of global competition. Drawing from the existing literature on economic interdependence and labor standards, this paper reviewed the various arguments for and against a social clause in the multilateral trade agreement. In light of the various practical problems involved in implementing such a social clause and the

possible unintended effects on efficiency and developing country growth prospects, the effectiveness of the social clause in advancing labor's welfare is open to question.

There is no question, however, regarding the necessity for legally mandated labor standards. Each nation will set its own level and mix of labor standards based on its calculations of the social good. In general, labor standards that promote opportunities for improving the workers' situation ought to be guaranteed while labor standards that are a function of the level of development of a country should be left as much as possible to bargaining between workers and employers.

Labor standards that cannot be enforced are of little use. The setting of labor standards should therefore consider the enforceability of such standards and the informational requirements to make the standards enforceable. From a policy standpoint more attention should be directed at building and strengthening institutional capacity for effective labor standards enforcement.

NOTES

[1] An exception so far has been organized labor in India.

[2]Labor standards may be formal or informal. Formal standards emanate from legislation, collective bargaining, and unilateral acts of employers, while informal standards derive from social custom or evolved practices in the workplace. This paper uses labor standards in the restricted yet more popularly understood sense, i.e., as originating from state intervention.

[3]See Simon (1991) for an elaboration. A more general discussion is provided in Hart and Holmstrom (1987).

[4]The fact that the worker has sold his labor power to the employer during the period contracted for implies that the employer has "residual authority" over the use of that labor power. However, because the worker essentially retains control over the exercise of his labor power, contractual incompleteness also implies that the worker is in direct confrontation with the employer over the unspecified use of the worker's labor power. The employer's and worker's opposing views on labor standards can then be understood in terms of these competing claims.

[5]The basic model is from Ehrenberg and Smith (1994).

[6]In fact, even in the presence of legal guarantees about conditions of work, employers still try to take advantage of any asymmetry in information that might exist between workers and themselves. For instance, if a worker is initially unaware of, or incapable of interpreting, a certain statute that might apply to his situation to improve his working condition, an employer can simply keep him in the dark about it.

[7]But even if they can successfully lead to improvements in work conditions, quits will tend to be "undersupplied" given that the decision to quit is irreversible and workers who quit cannot enjoy the benefits from the change (Freeman 1976).

[8]Note that this exit, albeit temporary, can be costly for the employer.

[9]The cost to the firm of installing safety measures or setting up a grievance resolution mechanism involves a substantial fixed component in contrast to the cost of paying individually differentiated wages, which is scale-independent.

[10]Expecting to benefit from the bargaining efforts of co-workers, each worker has an incentive to understate his demand for the standard.

[11] For a discussion of the transactions cost-minimizing role of institutions, see North (1990). Bardhan (1989) also provides a concise review of the literature.

[12] That is, the production conditions for the workers must be found to be "above average" in both social and economic terms (van Liemt 1989).

[13] See Freeman (1994) for a view of labor standards as an economic commodity.

[14]When the International Labor Organization (ILO) was founded in 1919, this same concern was reflected in the Preamble to its Constitution: "the failure of any nation to adopt humane conditions of labour is an obstacle in the way of other nations which desire to improve the conditions in their own countries" (as cited in Servais 1989).

[15]Labor standards may, however, increase productivity and enhance competitiveness. See Sengenberger and Wilkinson (1995).

[16]For a fuller discussion, see van Liemt (1989), although some of his arguments may have already been overtaken by events. See also World Bank (1995).

[17]See also the relevant articles in Sengenberger and Campbell (1994).

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COMMENTS

*Froilan M. Bacungan**

Can we help improve the worldwide implementation of labor standards by adopting the social clause? This is one legal aspect that may be looked at because we are interested in the workers and their working conditions. Any effort motivated by a desire to apply labor standards globally is a good one. But is the social clause really going to improve the labor situation?

We are probably all aware that work on international labor standards antedated human rights. The International Labor Organization (ILO) initiated this 30 years before the United Nations talked about human rights. ILO has developed a code whose conventions and recommendations are recognized all over the world as good standards countries should comply with. Will the observance of these conventions improve with the addition of the social clause?

I don't think so. For one thing, the efforts of the ILO in this regard, which hew to a national self-help theory, are already as good as they should be. The working conditions in a country are really a function of internal governance. Once we assume that working conditions are a function of external forces, we are lost. We must pressure our own government to change its policies if what it does in the area of labor standards is not in accordance with what we wish, instead of asking for outside help. It is insulting to the nationalist ideal to think that outside help, such as the labor social clause, is necessary for this purpose. We mentioned this at the Sixth Regional Congress of ILO held in Tasmania two weeks ago.

If we develop global competitiveness, the industrialized countries do not have to fear our products or services because they will not be based on low wages and lack of commitment to freedom of association. They will be based on the productivity of our workers and the greater use by our entrepreneurs of their talent for strategic thinking. So I would propose that the social clause be looked upon as an additional force in support of national initiative to bring about the implementation of international labor standards. But strengthening the existing machinery at ILO is perhaps the better alternative to the social clause.

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The *Time* magazine cover story on March 4, 1996 was on Pat Buchanan. If the United States would like to be protectionist, then so be it. If they don't want to patronize Philippine products because they think that this deprives their workers of jobs, then let them do that. Individual countries should have the option to be protectionist, but we should not allow protectionism in the guise of the social clause to be imposed as an international norm.

8. Impact on the Informal Sector

Amado M. Mendoza, Jr.

INTRODUCTION

The Philippine government's accession in 1994 to the Uruguay Round (UR) agreements of the General Agreement on Tariffs and Trade (GATT) represents the most wide-ranging and boldest commitment made by the country so far in favor of trade liberalization and market reform. It places the country under a tougher foreign trade regime since GATT-UR does not offer, unlike before, an *a la carte* option for state-signatories.

For the Philippines, GATT-UR is not a policy reform carried out in isolation. It is an important plank of an overall economic reform package started in 1986 and prefaced by a stringent stabilization program during the last years of the Marcos regime. There is special need to study the impact of GATT-UR because it is often argued that adjustment programs are patently anti-poor and anti-people. In doing so, however, we must recognize the difficulty offered by the fact that GATT-UR is part of a bigger package. It would be quite impossible to isolate its impact from that of the other reform programs.

This point is recognized by Rudiger Dornbush (1992) who wrote that "measuring the benefits of trade reform has been a frustrating endeavor." While most theoretical discussions argue that trade reform is beneficial, Dornbush lamented that "systematic attempts at quantification fail to single out trade policy as a major factor in economic growth." Following his logic, it will be equally difficult for a partisan for protectionism to attribute adverse economic impact solely on the prevailing trade regime.

To be sure, GATT-UR is not the first foray of the Philippines into trade liberalization. Yet, one must also note that the implementation of GATT-UR in the Philippines is being undertaken under changed circumstances:

First, it is being carried out under circumstances of renewed economic growth and required macroeconomic stability, which makes the adjustment costs theoretically smaller and more acceptable politically. In fact, it is being implemented as part of a more ambitious national development program to attain NIC-hood by century's end.

Second, it is being carried out in the context of re-democratization and popular empowerment. This makes the government more sensitive and vulnerable to charges that economic reform is anti-poor and anti-people. Furthermore, democratic settings (and bureaucratic politics) are hotbeds of policy conflict and inconsistency.[1]

Third, it is also being done in the context of decentralization and devolution of governmental functions and services—particularly in those lines (e.g., health services) that are of great interest to poor people.

Fourth, it is being implemented alongside other not entirely unrelated economic ventures and developments—ASEAN Free Trade Agreement (AFTA), Asia Pacific Economic Cooperation (APEC), and the growth of sub-national growth polygons (e.g., Brunei, Indonesia, Malaysia, Philippines-East ASEAN Growth Area, Northwest Luzon growth quadrangle).

In this paper, the interest focuses on certain key questions: What is the essence of the politics of trade reform in a developing country? How can reforming governments win the battle for reform given its political adversaries? How can government assist vulnerable social groups during market reform?

Any reform of an existing trade and economic regime will produce winners and losers. As early as the 13th century, Niccolo Machiavelli observed that "the reformer has enemies in all those who profit by the old order and only lukewarm defenders in all those who would profit from the new order." It is easy to see why groups

(labor, businessmen involved in "sunset" sectors, etc.) that will lose from trade and economic reform will protect their incomes and lobby their governments to restrict trade. However, those who would gain from the reform will not lobby equally strongly on the other side. Trade economists (e.g., Paul Krugman and Maurice Obstfeld, 1988) have long recognized that those who gain from economic reform and trade in any particular product are a much less concentrated, informed, and organized group than those who lose. For instance, the consumer beneficiaries of trade liberalization of sugar products would run to millions and are often unorganized while domestic sugar producers, who might be adversely affected, are obviously fewer, organized, and have the ability to act collectively and make political contributions to help thwart or adulterate trade policy.[2]

Indeed, questions about the allocation of the social and political costs of economic reform have generated bitter argument within both international development circles and within countries struggling with economic adjustment since the 1980s. A number of observers (Root, 1996; Przeworski, 1992; Dahl, 1992) draw our attention to the attendant problems of market reform especially in democratic polities. These problems can be grouped into two: **political support** and **state capacity**.

Political support for structural adjustment programs in the 1980s was sorely lacking all over the developing world. They entailed sacrifices from social groups not generally included in the negotiations. During adjustment, countries that suffer severe income inequality often experience political polarization. Notwithstanding their intrinsic technical merit, market reforms will be opposed when it is realized that some groups will benefit or suffer more than others.

Equity therefore is a major consideration in assessing the political feasibility of market reform. Joan Nelson (1992) points out that two distinct equity issues have emerged from the economic adjustment and reform processes in the developing world during the 1980s. The first, driven by humanitarian considerations, focused on reducing the impact of adjustment on the very poor, most of whom are rural. In most cases, the pressures from external institutions played an important role. The second was largely defined by domestic political pressures and focused less on the very poor than on the semi-poor and the urban working classes.

These two equity issues pose different political dilemmas. In the first case, while there are very weak domestic political incentives to assist the very poor (who are also relatively powerless and atomized), there has been considerable international pressure on their behalf that have developed since the late 1980s when economic adjustment sought to have a "human face" (*pace* Cornia, Jolly and Stewart, 1987). But while external agencies provided financial support for pro-poor programs in many countries, most of these programs were defeated by opposition from the more vocal political sectors who stood to lose by the reforms.

The second issue seems to be a greater problem in the Philippines and the rest of the developing world. In contrast to the very poor in the rural areas, urban working and "popular" classes are more organized and politically active and can pressure reforming governments through a variety of weapons—from the general strike to the ballot box.

In the Philippines, opposition to economic and trade reform has traditionally emanated from oligopolistic business interests, farm interests and organized labor. Moreover, oligopolistic business has displayed greater political sophistication since the downfall of Ferdinand E. Marcos in 1986. Realizing that multilateral funds were necessary to resuscitate the Philippine economy and secure the post-Marcos political regime, they paid lip service to economic reform to secure these funds and have fought rearguard skirmishes and battles since then. In fact, they made use of their positions in the Aquino government to perpetuate protectionist tariff barriers and block other anti-monopoly measures.

Curiously, these monopolists found "strange" tactical allies in organized labor, peasants, and other leftist forces in the country. Apart from a perception that these measures were being foisted by imperialist agencies, the less powerful classes were aware that they usually bear the costs of economic adjustment. For instance, the import liberalization program of President Corazon C. Aquino spared the "white-line" appliance industry identified with her trade secretary while certain agricultural sectors (e.g., cotton, sunflower seeds) were liberalized.

The tactical alliance may seem curious to a technical analyst who would argue that the lower classes (who are also consumers) will benefit in the long run from freer trade even if they may suffer short-run losses especially if they are employed in inefficient industries. The same alliance is intelligible, however, to Joan Robinson (1962) who quipped that "the invisible hand will always do its work, but it may work by strangulation." In addition, the visible hand of oligarchic interests and rent seekers will inflict further damage to lower class interests.

To dissipate local opposition to the Uruguay Treaty, the Philippine Senate cobbled up a multi-billion peso "safety net" package especially directed to peasant and rural beneficiaries.[3] In general, a reforming government may have to buy off opposition through such "bribes." However, its difficulties are compounded if it is in a financial bind and under an International Monetary Fund-prescribed austerity program which calls for a reduction of public deficits, among others. The question here involves the funding of these "reform-buying" efforts. The scramble for government funds will obviously have political implications for any reforming regime.

Fundamentalists will argue that the provision of so-called safety nets is contrary to the logic of the market. The technical objective of market reform, they argue, is precisely to eliminate non-competitive firms, industries, and sectors. These observers believe that the provision of safety nets will simply inject new life into these moribund sectors. Others believe that technical considerations should be tempered by political imperatives specially in a country with a substantial peasant and small grower population as well as a burgeoning (formal and informal) service sector.

But this brings us back to the financing problem. Some have suggested that multilateral agencies pushing for trade and market reforms in the developing economies such as the International Monetary Fund and the World Bank, should likewise provide funds for safety net packages. But this track may have to depend a great deal on the improvement of the capacity of many government bureaucracies to prevent the diversion of these resources to rent seekers.

It is quite clear that market reform entails a massive overhaul of state capacities in the developing world. The "orthodox paradox" stipulates that while reform calls for less intervention of the state in the economy, it requires the same state to initiate and sustain these same changes. The absence of state capacity is, in my opinion, a more important reason why economic reform can fail. Even when political support exists, it cannot ensure the successful implementation of reform. In situations where the bureaucracy is known to be corrupt or inept, the adoption of market reforms will not instantly transform it into an honest and competent one. A democratic state's dismal capacity to administer reform will also feed its political vulnerability. The inability of the bureaucracy to successfully fend off demands for continued preferential treatment for powerful vested interests will only fuel charges that reforms benefit some groups at the expense of others. Capacity, politics, and equity considerations are in fact intertwined.

To be able to come up with the proper policy and program responses to the new international trade regime, we must be able to identify the impact of the same on the various social sectors in the country.[4] We need to pay particular attention to trade liberalization's effect on marginal classes and the informal sectors.

In the main, it will be argued that the informal and marginal sectors and classes of Philippine society in their current state will be unable to benefit from GATT-UR. Market-enabling measures (or measures that enable people to effectively participate in economic markets) must be provided to enable the poor and marginalized to cash in on the economic potentials and opportunities offered by GATT-UR. Without these measures, the economic benefits will simply accrue to the not-so-poor and the already-entrenched.

I. DEFINITION OF TERMS/DIMENSIONS OF PHILIPPINE POVERTY

This paper makes use of the terms "informal sector" and "marginal sector." We should set aside some space to define these terms and indicate what they mean in the Philippine context.

If one reviews the appropriate literature (e.g. Feige, 1990 and Kelley, 1994), these concepts are immediately recognized as fuzzy, at best slippery, constructs. In fact, some commentators (Peattie, 1987) have suggested that the ambiguity of the terms is largely responsible for wide acceptance and usage. Feige prefers to use the umbrella concept "underground economy" which accounts for four types of economic activities: "illegal," "unreported," "unrecorded," and "informal;" and proposes several specific methods for measuring these underground types.

In Feige's taxonomy, the concept "informal" economy is largely shaped by the influential work of the Peruvian Hernando de Soto who stressed an essentially legalist conception of informality. Thus, the informal economy comprises those activities "that circumvent the costs and are excluded from the benefits and rights incorporated in the laws and administrative rules covering property relationships, commercial licensing, labor contracts, torts, financial credit and social security systems." Apart from legal status, informal economic processes have been defined in terms of production technology, non-normal profit rates, and the organization or control of production. Empirical studies typically use firm size as a proxy for the informal sector.

While Kelley's conceptualization of the informal sector is more limited,[5] he offers a number of key features of the informal sector, as follows: Informal production is organized around an individual, family, or small group of friends. This means that the direct producer controls the production process and receives the net product. In contrast, formal sector workers earn a wage. Informal production is more labor-intensive than formal sector production. Informal enterprises typically violate regulatory statutes and pay negligible taxes. Incomes earned from informal activity are less than formal sector incomes. While formal and informal output are similar, instances of product differentiation and imperfect substitutability abound. For instance, informal merchants sell goods in smaller quantities, offer different-quality goods (inferior packaging) and occupy different locations (street corners) compared to formal retailers.

While the ability to circumvent regulation and taxation results in higher disposable incomes in the short run, higher wages, greater stability of incomes, and superior working conditions make formal sector employment more desirable than informal activity. But due to rapid population growth, economic stagnation, and the capital-intensive nature of formal production, the formal sector cannot employ the entire labor force. Workers who cannot find formal sector employment are forced to develop alternative income sources in the informal sector. All in all, belonging to the informal sector connotes subordinate or inferior status *vis-à-vis* the formal sector.

These features of informal employment are validated by initial empirical work in the Philippines. A 1987 study conducted by the University of the Philippines School of Labor and Industrial Relations (Gatchalian *et al.*, 1987) established that urban informal activity was predominantly vending work concentrated on selling commodities which range from cooked or processed food to nonfood items; that those engaged in this sector tended to be predominated by women and child labor; and that informal activity was essentially a coping mechanism in the face of economic adversity. Furthermore, the urban informal sector largely caters to the needs of the urban poor community.

On the other hand, the term "marginal sector" does not often surface in development literature and appears to be used exclusively in the Philippines. Here, the poor are segmented according to severity of poverty. Extreme poverty is equated to marginalization; and marginalization in turn means either exclusion or inability to participate or compete in markets. Exclusion from the market is largely a function of deficiencies in education, health, and skills.

According to the *Philippine Human Development Report 1994*, those who belong to the marginal sector include "subsistence producers such as upland farmers, small fisherfolk, landless farm workers, unskilled workers, scavengers in the cities, and others."[6] The same report locates the marginalized in the so-called "core" or "subsistence" poor, to differentiate them from the "survival" poor, or those who are closer to escaping poverty (measured according to an income threshold). Accordingly, subsistence poverty refers to the

"inability to earn enough income to meet the minimum food requirements of a normal person (i.e., 2000 calories per day)." In 1991, there were 2.42 million Filipino families in subsistence poverty, or about one in every five Filipino households.[7]

Another work (Balisacan, 1995) divided the poor into three segments: the "ultra poor," the "near ultra poor," and the "marginal poor." The "ultra poor" are those whose per capita expenditures fall short of the food threshold set by the National Statistical Coordination Board's Technical Working Group (NCSB-TWG) on Poverty Determination. The "near ultra poor" are those whose expenditures are greater than the food threshold but are less than the mean of the food threshold and the poverty threshold (or *m*). The "marginal poor" are those with expenditures greater than *m* but less than the poverty threshold. The "ultra poor" therefore corresponds to the PHDR's "core" or subsistence poor while the "marginal poor" is equivalent to the "survival" poor.

There are obvious overlaps between the two concepts—**informal sector** and **marginal sector**. For instance, subsistence producers may be included in both sectors. But it is also clear that the two sectors are not one and the same. It remains both a conceptual and empirical matter to fully sort out one from the other.

In the introductory portion of this paper, the informal and marginal sectors are equated with poor people. We do this for the following reasons:

1. Informal sector incomes are lower compared to formal sector incomes.

2. Informal employment is less stable and secure than formal employment.

3. Informal employment does not enjoy legal protection.

4. Marginal people are unorganized and politically weak.

5. Marginal people, e.g., subsistence farmers, are not full market participants.

If we are interested in the impact of GATT-UR on the Philippine poor, the heterogeneity of the poor must be recognized from the very start. A distinction between urban poor and the rural poor must be made. While conditions of the urban poor are not exactly laudable, their lot is comparatively better than that of the rural poor. This fact will introduce some policy dilemmas since the urban poor has stronger political clout than the rural poor. As alluded to earlier by Nelson (1992), governments may be more compelled to buy off the opposition of urbanites than to attend to the needs of the rural poor.

A distinction must likewise be made between the margins of poverty, the ultra-poor (or the poorest of the poor), and the marginal poor (or those who are close to the poverty threshold and are poised to leave poverty behind). The geographic, gender, and ethnic dimensions of Philippine poverty must likewise be recognized. In the Philippines, poverty is more the domain of women, non-Catholics, ethnic minorities, and depressed regions (Bicol, Cagayan Valley, Eastern Visayas and Muslim Mindanao).

II. ECONOMIC ADJUSTMENT, TRADE LIBERALIZATION AND GATT-UR

By now, it is widely recognized that the 1980s formed an extraordinary and perverse era for Third World countries like the Philippines. In the previous decade, the threat of international financial collapse due to massive Third World debts was averted at the expense of growth in many developing nations. In some nations, the gains of a decade or more in real per capita gross national product were erased. In the Philippines, the contraction of the economy in the 1984-1985 period represented its worst economic crisis since the Second World War and led to the demise of the Marcos regime in 1986.

When short-run responses failed to rekindle sustained growth in the debtor nations, more comprehensive adjustment packages were designed together with international creditors and the Bretton Woods institutions. The adjustment of individual nations usually comprises two distinct though related tasks: stabilization and

structural reform or structural adjustment. **Stabilization** includes the reduction of balance of payments deficits and inflation. The essence of orthodox stabilization efforts is reduction of aggregate demand through stringent fiscal and monetary policy measures often accompanied by devaluation.' A recession usually results even as these tough measures accomplish their balance of payments (BOP) and price level targets.

The second aspect of adjustment is **structural reform** designed to encourage foreign exchange earning or savings activities and, more generally, to improve incentives and efficiency for sustained economic growth. While the specific measures adopted under this rubric vary widely depending upon individual country circumstances, they usually involve those that intend to open national economies to international markets, and a redefinition of the roles and limits of states and market forces in promoting growth and other national objectives. The usual components of a structural reform package include trade liberalization and tariff reform, deregulation, privatization, tax and property reform, and administrative reform of state bureaucracies.

Kahler (1990) identified three major challenges to economic reform orthodoxy which also developed during the previous decade. The first is the **neostructuralist** school, exemplified by Lance Taylor (1993), Banuri (1991), and the World Institute for Development Economics Research (WIDER). Neostructuralists strongly assert that developing economies are structurally different as a group (compared to the developed economies which were argued to have thrived by following orthodox prescriptions) and that each developing country deserves independent analysis and individualized policy prescriptions. In this light, orthodox analysis and prescriptions may apply to some and may not in others. Neostructuralists are particularly critical of the perverse effects of orthodoxy, especially its propensity to trigger recessions and lower economic growth.

The second alternative—eclectic or heterodox stabilization programs adopted in such countries as Israel, Brazil, Argentina, and Peru during the 1985-1986 period—is closer to neostructuralism in its intellectual roots. The restoration of democracy in these

countries created the political pressure to avoid economic recession at all costs. Instead of restricting demand, these countries tried to control inflation through the use of wage and price controls. But they also made use of orthodox measures such as devaluation and cuts in public spending. Israel, blessed with very high levels of external finance, is the only successful case of heteredox adjustment.[8]

The third alternative is the aforementioned "adjustment with a human face" approach of the United Nations Children's Fund (UNICEF) which is gravely concerned with the adverse impact of economic adjustment on the more vulnerable sectors of developing economies. This approach differs from heterodoxy by insisting that special programs targeted at particular groups—children, women, the very poor—be implemented alongside orthodox measures.

Kahler's listing of alternatives is obviously not exhaustive. The experience of the Northeast Asian newly-industrializing countries (NICs) suggested the efficacy of what Walden Bello (1995) tagged as the "pragmatic zig-zag" approach where the state can "zig from liberalization and zag to strategic protectionism" in pursuit of national interest and where the state's moves may not be theoretically consistent but are oriented only to developing the economy's "strategic depth" and capacity.

Nevertheless, orthodoxy reigns supreme over the developing world today, aided by the impact of the collapse of statism and *realsozialismus*, World Bank-supplied pressure and financing, and previous poor economic performance. Whether the swing of the policy pendulum, from protectionism in the 1950s and 1960s to economic openness and trade liberalization in the 1980s and 1990s, will deliver the developing world "out of the wilderness" of economic crisis remains a question, however.

As indicated earlier, much of the discussion and agitation over economic adjustment revolves around its impact on the poor. But to be able to generalize on the matter means we have to know who the poor are, the roles they play in the national economy, and the extent of their vulnerability to economic adjustment. In general, this

information is not generally available but the need for such knowledge is accentuated by the heterogeneity of the poor. In fact, the impact of economic adjustment on them depends largely on what they do, where they get their incomes, and their position in the national economy.

Thus, the urban poor tends to bear many of the short- to medium-term adjustment costs as a result of public sector retrenchments, other frictional unemployment, and possible losses of food subsidies and other welfare services. With respect to the rural poor, much depends upon their access to land and whether those with land are producing cash crops (most likely to benefit from higher export prices) or local foods (whose relative prices may not change). If the rural poor are net buyers of food (especially with imported inputs), they may be adversely affected by the reform. And lastly, the more they are integrated into the modern market economy, the more vulnerable they would be to the effects of the adjustment program. Given the poor's heterogeneity, one can make the "soft" claim that some of the poor will gain and some of them will lose in the process of economic adjustment.

How can freer foreign trade help the poor?

For developing countries like the Philippines, it is often suggested by mainstream economic theory that foreign trade exposure will lead to more equitable income distribution. This argument is made first by noting the pathologies of a protectionist trade regime for a nation's poor and for income distribution.

First, protectionism affects the economic structure with its orientation toward more capital intensive import substitution industries. To the extent that labor is discriminated against in such a trade regime, incomes are not earned by the unemployed poor and accrue almost entirely in the hands of the owners of capital. Second, protectionism gives advantages to importers and the civil servants responsible for granting import licenses or foreign currency where there are concomitant foreign exchange controls. Third, the rent-seeking opportunities of trade protectionism spawns a cat-and-mouse game similar to what had been observed in *realsozialist* polities like the defunct Soviet Union. To the extent that the bureaucracy is given

the authority to grant import licenses or allocate precious foreign exchange, valuable monopoly rents are created. The rational economic reaction of private actors is predictable; private actors will find means—legal, extralegal, and illegal—to capture these rents. The political reaction in turn is to attempt, through additional controls (and hence more bureaucrats), to thwart this behavior. In doing so, the value of the rents will appreciate, the private demand for them will intensify, so that more bureaucrats, controls, and regulations are needed.[9] The additional public expenditure generated by this perverse game are resources that could have been spent for the nation's poor.

In support of the view that a freer trade regime could lead to more equitable income distribution, three parallel theoretical arguments are forwarded:

1. Trade openness will eliminate the bias for capital-intensive industries. Openness will reveal that a developing nation's comparative advantage will lie in its most abundant resource: its labor.

2. The elimination of policy bias for capital could lead to the expansion of labor-intensive export products. More poor people employed in the export sectors means more incomes for them. Even if the incomes they earn are lower than those in other formal sectors (because of their relatively low skills level), these incomes are better than the subsistence levels previously earned. Their standards of living would be even lower if these labor-intensive industries were not established as they would have remained unemployed, underemployed or engaged in subsistence activity.

3. Trade openness eradicates the monopoly privileges of those with import licenses and requires the reduction of public expenditure for control bureaucracies.

The entire happy situation is painted in this manner. First, the cases where no government intervention is needed are discussed. The development of export crops has a highly beneficial effect on poverty and income distribution. In the long term, given favorable natural conditions and continued competitiveness, the expansion of this sector leads to the disappearance of subsistence farming which is usually associated with ultra-poverty. This expansion also has a very important indirect effect as it gives rise to a very marked wage increase in the modern urban sectors. The effect is particularly great on unskilled labor as the reserve of very low-productivity rural labor disappears together with subsistence agriculture.

The expansion of the labor-intensive export industries will also help absorb urban unemployment and surplus rural labor after which the wages of this often low-skilled labor will rise more quickly than other wages, rapidly diminishing income inequality. This view is made after a consideration of the Northeast Asian NIC experience which supposedly reveals two phases of development.[10] In the first phase, the export industries employ labor which is either unemployed or scraping a living in the informal sector. In this manner, the absolute numbers of the poor are reduced without changing the income hierarchy. In the subsequent stage, surplus labor disappears and export enterprises have to offer substantially higher wages to low-skilled labor if they are to find workers. This brings about a marked reduction in income differentials to the advantage of low-income workers and diminishes poverty in the country as a whole.

The practical record, however, appears to be a mixed one. Francois Bourguignon and Christian Morrisson (1989) reveal that the direct effects of foreign trade apparently depend upon the features of the exporting sectors, thus:

1. Where there is little concentration of ownership in agricultural assets (land particularly), the development of export cash crops always has a double beneficial effect in reducing both income inequality and poverty. However, these beneficial effects are not extended to subsistence farmers or those who fall into the poorest category of rural households. This section of the farming population is simply unable to respond to market opportunities even if they are available.

2. On the other hand, where land ownership is concentrated, export agriculture often has an adverse impact on income distribution and poverty. Agricultural export revenues reinforce the income gap between low-waged farm workers and the large landowners. Furthermore, a rise in the world price of the agricultural export will accrue almost entirely to the landowner. The situation is further aggravated if wages are depressed by income supports farm workers enjoy from subsistence agriculture (usually done by the wives and children of the family). On the other hand, the level of unionization among farm workers may have a beneficial effect on their wages. In general, the greater the degree of trade unionization, the higher the wage levels. But the high wage levels may also prevent higher employment levels in the rural areas.

3. The growth of labor intensive manufactures also has a double beneficial effect on income inequality and poverty.

4. Mining activities have mixed effects depending upon the manner in which the land rent is appropriated and used. Appropriation by the state has the potential of net income equalization. However, much will depend upon the direction of state expenditure.

5. On balance, the impact of marketing (of export products) activities is usually neutral. The most notable exception is when the state draws off some of the export revenue (usually in the form of an export levy) to benefit other groups, especially urban households which on the average have higher incomes than small farmers or manual agricultural workers.

As Gary Fields (1988) puts it, foreign trade per se does not automatically help the poor. It does so only if the exported products make full use of the resource that they have the most: their labor. Furthermore, as Henry Nau (1989) asserted, opening markets alone cannot account for economic prosperity. If countries offset the reduction in trade restrictions by altering domestic policies (e.g., contracting demand), changing exchange rates (e.g., maintaining an overvalued exchange rate) or manipulating capital flows (e.g., restricting foreign financial and direct investments), trade

liberalization may not result in expanded output and productivity. Trade liberalization requires some domestic policy disciplines, exchange rate surveillance, and appropriate capital market arrangements. For equity's sake, the state may have to initiate land reform (only to the extent that it will not adversely affect investment and production), adopt minimum wage levels, or levy and effectively distribute part of the land rents.

How can trade liberalization and economic adjustment harm the poor?

The heterogeneity of the poor in any nation also precludes across-the-board generalizations about the adverse impact of trade liberalization and economic adjustment. Nevertheless, the bottom line will be to assess whether the promised economic benefits will be realized.

Notwithstanding the preceding discussion, especially if we consider the record of economic adjustment in the 1980s, it may be concluded that the urban poor tends to bear many of the short- to medium-term costs of overall economic adjustment. One danger that particularly affects the urban poor is the loss of jobs resulting from the decline of uncompetitive manufacturing industries (to the extent that these are concentrated in urban locations). Rural jobs and incomes are also threatened by more competitive agricultural imports.

Another danger arises from the cutbacks in government spending associated with attempts to reduce absorption and public deficits. At first glance, trade liberalization appears to be unconnected to this peril. However, if one associates the lowering or elimination of border taxes on tradable goods with trade openness, then trade policy will certainly impact on the level of public revenues and expenditures. The foregone trade revenues may likewise lead to reduced public spending. Government efforts to regain monies through internal taxation (especially indirect taxes because of administrative considerations) will introduce complications. The comparative tax burdens of these new levies will have to be assessed. On the other hand, to the extent that freer trade can spur economic growth, growth in turn can increase public revenues.

Much of the burden of the public spending cuts falls upon the economic services provided by the state and its investments in the economy's infrastructure, and the poor are likely to lose from these reductions. The government may tend to cut back on food subsidies as these often place severe burdens on the budget. This seems to be the case with the National Food Authority (NFA) for which government financial support has been declining over the years. It is true that general food subsidies are an inefficient way to protect the poor during economic adjustment because those who can afford to pay market prices capture many of the benefits. The subsidies may also have the effect of depressing prices paid to farmers, who themselves are poor. Nonetheless, some of the poor (especially the urban poor) do gain from these subsidies and can be badly affected by cuts.

There is also a serious danger that the quality of social services will suffer during times of budgetary stringency, even when the share of social spending is protected. Government may hesitate to reduce the number of civil servants because of political considerations and may instead prune the supporting expenses which make them productive and useful to the poor: medicines for clinics, books for schools, and transport for social workers.

To the extent that farm produce prices increase in response to freer international trade, the poor are harmed if these increases will also translate into higher consumer prices for food products. Net food buyers (the urban poor and the subsistence farmers) amongst the poor will be adversely affected by this development. In other cases, severe land inequality further prevents poor people from gaining from, or responding to, liberalizing reforms. In particular, it raises the danger that reform will hurt the poor through more expensive food staples. Meanwhile, net food sellers (the rural non-poor) reap immediate gains from the food price rises.

The poor may also lose from any slowdown in economic growth that results from economic reform. Any reform means the abandonment of old ways and the trying out of new ways. In the process, dysfunctionalities, discontinuities, and the costs of relearning may affect levels of production.

What in GATT-UR can be of interest to the poor?

The key provisions of the GATT-UR agreements that may specifically affect the interests of the poor of the developing world include the new discipline on agriculture and textiles, intellectual property rights, and trade in services. The provisions on agriculture mandated on state-parties are clustered around four areas of concern: increased market access, domestic support, export subsidies, and sanitary and phytosanitary measures.[11]

Among the specific provisions regarding market access are: (1) tariffication or conversion of all quantitative restrictions on agricultural imports into tariffs; and (2) the binding of all tariffs, the reduction of tariffs from the bound level (with an average reduction of 36 percent over six years for developing countries and 24 percent over 10 years for developing countries), and the provision of minimum or current access opportunities for products which have been tariffied, equal initially to three percent of the domestic consumption of the product and growing to five percent over the implementation period. Developing countries are given the privilege of offering "ceiling bindings" which are set at levels above the present rates.

With respect to domestic support and export subsidies, state signatories must impose ceilings on and eventually reduce the level of production and export subsidies given to domestic producers to at most 10 percent of the gross value of agricultural production. Not included in the category of domestic support are public expenditures for agricultural research, extension, irrigation, market infrastructure, and other productivity-enhancing investments. Income support programs to farmers that do not affect the levels of production and trade are also excluded.

Transparency is also promoted through the harmonization of sanitary and phytosanitary (SPS) regulations, legitimate rules that may be abused by countries to protect local industries. The agreement provides that existing SPS practices be based on internationally accepted procedures. Member countries can only be stricter than these standards if justified scientifically.

The argument has been made that since the Philippines is a net agricultural exporter, it will benefit from a GATT-UR agreement on agriculture. The opportunities for unfair trade in agricultural products, by way of developed country production supports and export subsidies, will be clipped to the benefit of poorer countries which cannot provide the same protection for lack of budgetary resources.

Since the Philippines does not have export subsidies and the level of production supports such as fertilizer subsidies, credit programs, and the like, is well below the 10 percent limit, much of our commitments under GATT-UR are in the area of market access. Specifically, the tariff reductions the government has promised may adversely affect crops currently protected by quantitative restrictions: rice, corn, sugar, livestock, meat products, coffee, cabbages, onions, and garlic. For this reason, much of the criticism and fears raised by organized peasants and other sectors are over a possible flood of cheaper and agricultural products from the industrial economies and the possible loss of employment in the agricultural sector.[12]

As requested by the Philippine government, rice has been exempted for the next 10 years, although a minimum access requirement (from one percent or about 60,000 metric tons in the first year of implementation to four percent or about 240,000 metric tons at the end of 10 years) was imposed on the staple. But the minimum access tariff has been set at 50 percent, which is much higher than the historical equivalent tariff (at 30 percent) resulting from the NFA trade monopoly. (David, 1995)

In addition to higher binding tariffs, the agreement provides for a special safeguards duty aimed against import surges which may result in serious injury to domestic agricultural products. But this measure is only available to farm products whose nontariff barriers have been converted to tariffs.

David (1995) also argues that large capitalists and farmers dominate the corn, sugar, poultry and livestock sectors and that the costs of trade liberalization will be borne mainly by the relatively high income group of landowners and capitalists. However, the agricultural wage worker in these sectors may have to weigh the

benefits of lower prices of these food products against possible loss of employment. The point is that even in these sectors, the costs of adjustment are not limited to capitalists and landowners alone.

GATT-UR has the potential of opening new markets for some Philippine products like pineapples, bananas, garments, and some electronic products. Following the earlier Bourguignon-Morrisson analysis, the gains from increased exports of pineapples and bananas will accrue largely to landowners and capitalist plantations if much of the production is done on large estates, though some of these gains may trickle down to subcontracted farmers.

A related fear is raised with respect to long-standing programs trying to promote self-sufficiency in rice and corn as part of the country's overall food security program. These fears were resurrected anew with the 1995 rice crisis. Of particular interest here will be the handling of the incompatibility of an existing law, Republic Act No. 7607, or the Magna Carta for Small Farmers, which specifically prohibits the importation of agricultural products produced locally in sufficient quantities, with the country's GATT-UR commitments.

Concern has also been aired regarding the new discipline on intellectual property rights (IPR) that critics fear will lead to continued technological dependence even for modern farm inputs on monopolistic transnational corporations. A more specific policy and research question for the Philippines is: How will the IPR provisions affect the country's generic drug policy, a policy which had afforded the poor access to low cost quality drugs? A related fear is raised over the activities of American and other Western research centers, organized as the International Human Genetic Diversity Project, toward the patenting of human cell lines of indigenous peoples the world over without the latter's knowledge and consent. These human cell lines will be used to develop commercial products to be used to treat or diagnose humans afflicted with various maladies such as the adult leukemia virus and chronic degenerative diseases. In the Philippines, the project plans to collect cell tissue from the Sulu, Batak-Aeta, Ati in Panay, Mamanwa, Agusan Manobo, Zambales Aeta, Agta, Batan, Yami, and Ifugac tribes.[13]

A greater concern raised by peasant groups and indigenous peoples about marketization (a process that is facilitated not only by GATT-UR) falls under the rubric of "development aggression". As marketization and internationalization proceed apace, the economic use of scarce assets will continuously be assessed and reassessed by entrepreneurs. Since the country has long reached its land frontier, "development aggression" has largely taken the form of "land conversions" which are essentially economically rational redeployment of agricultural land into uses which command higher returns. Farms are increasingly converted into industrial estates, science parks, golf courses, and the like. Even public and inalienable lands are not spared. These land conversions have resulted in the displacement of poor communities from their homes and means of livelihood. These projects have not automatically provided them with alternative employment and have resulted in misery and greater poverty. In some instances, conversion has resulted in the reversal of agrarian reform gains.

Much of the NGO (nongovernment organization) criticism against "development aggression" is largely imbued with a new human-rights-and-development perspective boosted by recent international initiatives such as the 1993 World Conference on Human Rights in Vienna and the 1992 Earth Summit in Rio de Janeiro. This new perspective calls for the universality, indivisibility, interdependence, and interrelatedness of all human rights. Earlier, economic and social rights tended to be neglected in favor of civil and political rights. The older understanding considered the fulfillment of the duties specified in the International Covenant on Economic, Social and Cultural Rights as dependent upon the material and technical resources of the individual state-signatory—hence the term "progressive realization" in the Covenant's Article 2.

The new view (argued in Patricia Feeney, 1994) stipulates that, based on the experience of poor people the world over, poverty tends to be characterized not only by material insufficiency but also by denial of rights. In some cases, this involves the violation of civil and political rights; in others, the withholding of social and economic necessities. It concludes that political participation and economic empowerment are necessary elements in all successful development

programs. Investments in poverty alleviation and popular empowerment are investments in production. In effect, without investments in human beings, there can be no real development. Appropriately, Article 8 of the 1993 Vienna Declaration intones: "Democracy, development and respect for human rights and fundamental freedoms are interdependent and mutually reinforcing."

III. WHAT CAN BE DONE FOR THE POOR DURING ECONOMIC ADJUSTMENT?

At the outset, a fundamental principle must be stated unequivocally: Poverty alleviation in developing countries is a valid social goal and must underpin all attempts at economic adjustment. In the long run, it serves as the yardstick for evaluating the success or failure of economic reform and public policy. In this sense, the discussion in this section can apply to poverty alleviation efforts undertaken with or without trade liberalization or market reforms. Nevertheless, it may be argued, as Carol Graham (1994) has done, that governments may take advantage of the political and economic dynamics created by economic reform to redirect public resources to previously marginalized groups, or those previously excluded from state benefits. The likelihood of successful economic reform in any single country depends to a large extent on the legitimacy of its regime. To this end, Maravall (1994) argues that when democracies protect those in the most vulnerable positions, they exhibit the humanity that is a basic component of their legitimacy.

Following Lionel Demery and Tom Addison (1987) and Tony Killick (1993), the following basic approaches may serve us in the design of pro-poor programs during difficult economic adjustment programs:

1. Raising the poor's access to productive assets like land;

2. Raising the returns they can achieve from the productive assets they already possess, for example by providing access to markets or by extension advice;

3. Improving their employment opportunities;

4. Improving their access to education and health services; and supplementing their resources with transfers, for example through food subsidies.

The humane adjustment school adds certain broad principles. Measures to protect the poor are much more likely to be effective if they are built into the original design of an adjustment program than if they are treated separately or added as an afterthought. Tokenism is a real danger here. Toward this end, the special and differential treatment (SDT) still allowed by GATT-UR for developing countries should best be used for crafting and implementing these measures.

Raising the productivity and incomes of the poor is central to any strategy for improving their material well-being. One aspect of this task is to try to find ways of increasing the participation of the poor in sectors of production that can be expected to grow in the process of structural change. In the case of GATT-UR, this means a careful but skillful identification of industries that will be stimulated by overall trade liberalization, and the specification of the skills and capabilities that must be developed among the poor so they can take advantage of these new opportunities. This will likewise entail the provision of appropriate supports such as infrastructure, marketing arrangements, and the like.

While not to be ignored, a pronounced bias in favor of the "hard" components of economic development such as roads, bridges, irrigation works, and other "public starts" will only further enable those who are already active participants in the economy. The only way to ensure the active economic participation of the ultra-poor both in the urban centers and the rural areas is to develop their productive capabilities toward a virtuous accumulation of human capital. Central to this capability building process is the state of their health, nutrition, and education. A better fed and healthier, more knowledgeable worker is certainly a more productive, more enterprising individual. And more productive individuals will enjoy better incomes. Obviously, state resources must be allocated toward this direction.

Investment in education appears to be a key measure. If lessons are to be learned, we should do so from the East Asian economies which have experienced rapid growth over three decades with relatively low levels of inequality and which appear to have also achieved reductions in income inequality. According to Nancy Birdsall and her associates (1995), policies adopted by the East Asian NICs that reduced poverty and income inequality, such as emphasizing high quality basic education, also stimulated economic growth. Rapid growth and reduced inequality in turn led to higher demand for, and supply of, education. In effect, investment in education is a key to sustained growth, both because it contributes directly through enhanced productivity and because it reduces income inequality.

If the conventional wisdom regarding the trade-off between growth and equity is challenged anew, the related hoary and ahistorical contraposition between markets and state activity is also being reexamined. Michael Lipton (1995) underscores the need to reconcile market reform and state redistributive reform. He argues that these two types of reform are dynamic complements in reducing poverty and in achieving economic growth. Redistributive reformers in 1950-1975 often underestimated the dependence of their proposals on more robust markets. As a result, even if the poor obtained some education or land, the products and incomes from these new resources were restricted by market or price distortions.

Conversely, market reformers since the 1980s have denigrated the complementary role of redistribution. Free marketeers have eschewed redistribution largely because states oversee these efforts; and because states are involved, many of the would-be redistributed reforms directed resources (credit, food, land, etc.) not to the poor but to the rich and the bureaucrats. What they overlook is the fact that states, and their supposedly rent-seeking agents, are the agencies that carry out reforms, including market reforms. These market reformers fail to see that people with neither education nor land are often unable to capitalize on new market opportunities. Untrained and asset-less human resources will remain underused and unresponsive.

Proper attention must be paid to the administrative machinery for helping the poor. The efforts are more likely to succeed when a wider range of government departments and other agencies (including private volunteer organizations) is involved in program design than the usual concentration upon the ministries of finance and economic planning. This is true even though coordination problems multiply as more agencies are brought in.

Lastly, programs for the poor should incorporate mechanisms to monitor their impact on the poor and the effectiveness of the safeguards designed to protect them. A special concern is preventing the diversion of benefits and resources to the not-so-poor or even the affluent. Correct targeting of programs is therefore important; this makes the necessity of research on the poor's features and characteristics clearer. Necessarily, this will mean a shift away from services that disproportionately favor the urban areas in favor of providing more primary health and education, rural water supplies, and the like.

However, Arsenio Balisacan (1995) reminds us that the problems attendant to targeting must be recognized fully. Since information about the poor is difficult and costly to acquire, planners may resort to a generalized or universal subsidy program which provides a subsidy to everybody in the population. But a universal scheme is in itself costly since even those who are not needy receive subsidies. The politics of subsidies may further result in an inefficient situation as most of the subsidies devolve to the non-poor. At the same time, efforts to remedy the situation require costly information and research updates as well as a larger administrative setup. In general, targeted subsidy programs require greater financial outlays and a more competent administrative setup than a universal program.

The World Bank has recently urged the Philippine government to reevaluate and remedy the inefficiencies of its social safety net programs for the poor. In the World Bank's view, only a few of the resources currently spent on livelihood programs reach the poorest groups. In addition, the costs of administration are high. The multilateral agency has also asked the government to remedy the fragmentation of the programs as well as the failure to mobilize target communities to help themselves.[14]

Although women's poverty in developing countries is not intrinsically different from that of men, their share of poverty is disproportionately large. While the data used are rudimentary ones taken from the 1990 labor force survey, the Philippine Human Development Report 1994 said that for the Philippines as a whole, average earnings of females were only 41.84 percent of the average earnings of their male counterparts. Some eight of 13 regions reported averages lower than the national average with Central Mindanao reporting the worst ratio: only 20.3 percent of average male earnings.[15]

Even as they are economically disadvantaged in general, it is argued by Mayra Buvinic and Margaret Lycette (1988) that women's economic contributions in poorer households are important along three indicators: their proportional representation in household budgets, the women's role in promoting child nutrition, and their importance in periods of economic distress. First, all over the developing world, it has been shown repeatedly that the earnings of adult women are proportionately more important in poor households than among the well-off. It is mainly the women in poor near-landless and small holder households who resort to wage labor or artisanal work to supplement family incomes. Second, since children of lower-income earning mothers are nutritionally worse off than the children of richer mothers, efforts to raise women's incomes are critical to the provision of high quality food to infants and children. Third, adverse economic conditions in the 1980s seem to have increased the participation of poor women in formal and informal labor markets to help compensate for the loss in real household incomes. From the foregoing considerations, it is clear that attempts to expand women's economic opportunities and raise their incomes should be a preferred anti-poverty strategy.

From women, we move on to children, clearly among the more economically vulnerable sectors in any society. We have earlier alluded to the robust correlation between education and growth. Children deprived of adequate education, health care, or nutrition often grow up unable to fulfill their initial potential. Given the long-term and continuing nature of economic adjustment, a society's capacity to capitalize on market reform is enhanced to the extent that its children reach adulthood able to perform well in markets.

Lipton (1995) points out that children's rights are relatively undeveloped partly because parents' and children's rights are often in conflict and partly because children, by definition, are neither fully rational nor fully able to articulate market demands. Notwithstanding this conflict in rights, most analysts and governments concur that: children's interests in receiving some education override conflicting claims by parents that a child must work (even if with his/her consent); parents' rights to compel children to go to school override the possible wishes of children to do other things; child workers' needs for special health, safety, timing, and schooling conditions are superior to employers' claims to freedom of contract.

There is also some consensus that the state should intervene to enforce these overrides (even without children's and/or parents' consent) by: compelling all children to obtain some schooling; making this viable by compelling communities to support such schools, thus making basic education free or near-free (at least for children of poor parents); and prohibiting and/or regulating child employment.

Protecting children's rights may prove to be problematic if market reforms and expansion raise in the short run the demand for child labor. Widespread child labor may boost short-run competitiveness in products where children can be paid less per unit of output than adults by particular employers.

IV. CONCLUDING REMARKS

The following conclusions can be made. First, there will be great difficulty in completely isolating the effect of GATT-UR on the informal and marginal sectors of the Philippine economy—the Philippine poor—since it is part of an overall economic liberalization program.

Second, technical and political analysis of economic liberalization in general and trade openness in particular indicates that these economic reforms have the potential in the long run to better the incomes and living standards of the country's poor.

However, this same analysis admits that the short-run costs of economic adjustment may disproportionately fall on the poor and the politically marginalized. For this reason, the GATT-UR provides for a longer adjustment period for developing countries especially with regard to the liberalization of agricultural trade and the implementation of intellectual property rights.

Third, any economic reform may have three phases: the introductory phase; the consolidation phase; and the deepening and completion phase. The precise challenge of any economic reform (which may be technically correct but politically unpopular) is to "sell" it well at least in its introductory phase, generate the necessary political support to consolidate it, and enable graduation into the completion phase.

The opposition to the reform of affected sectors and interests may be considered to be "irrational" from an efficiency viewpoint. However, this opposition must be considered as real and rational from a political perspective. The opposition coming from the politically active and organized sectors which claim to represent the interests of the poor must not be summarily dismissed as noises aired by narrow interests. To fight for one's interests is politically rational; to cloak one's interests as the interests of greater society is also to be expected. Furthermore, efforts of affected sectors to pass on the costs of adjustments on others is a political fact.

Fourth, any reforming government will have to make a better go at the social marketing of economic reform. One cannot ignore the obvious truth that in most cases the argument for free markets is too intricate to be intelligible or convincing to the general public, not least to the victims. To be sure, its task is made difficult in a social situation where mass understanding of economics is poor (as asserted by Dr. Mahar Mangahas of the Social Weather Station), where memories of the social costs of earlier economic reform episodes are quite vivid, and where populist politicians can find a ready and appreciative audience.

To be sure, political support for initially unpopular reforms which bear their intended beneficial fruits will materialize after the fact. Reforming governments will have to contend with the Olson syndrome—that the beneficiaries of economic reform are not as inclined to demonstrate their support compared to those who would be adversely affected by change. But reformers need not just accept the existence of this syndrome. Governments may have to actively seek out the sectors benefited by reform, solicit their support, and communicate this support to the rest of society in a credible and sustained manner. The basic point is, as Manuel Montes (1994) puts it, *if* economic reform meets the opposition of the politically powerful, **the political support of the supposed beneficiaries should always be welcome.**

To further broaden political support, democratic governments will have to adequately protect the vulnerable during the adjustment period. These efforts must be undertaken with the myriad of private organizations (people's organizations, NGOs, volunteer groups) who are currently working within these sectors in order to build trust, strengthen capabilities, and reduce dependence. It may even be argued that government assistance to the marginal groups who have never enjoyed state support before may enjoy greater political returns compared to a strategy of buying off the opposition of groups that will sustain real and permanent losses due to reform and will therefore oppose them even if they are compensated. Nevertheless, for this political support to materialize, these same marginal groups must likewise be empowered to participate in the political arena.

But assistance to the poor also introduces other moral and political dimensions. A government may have to make hard decisions in its pro-poor policy and program mix. It may make sense to target assistance to the near-poor than to the ultra-poor despite moral imperatives. The marginal benefits of the assistance may be more substantial in enabling the escape of some from poverty instead of simply alleviating the conditions of the ultra-poor without decreasing overall poverty. For example, if the poorest are malnourished and sickly (and most of them are), they may not be able to take advantage of increased public expenditure on education. In addition, it also costs more—in terms of resources and administrative time—to reach

the poorest and raise them above the poverty line. To this end, it will be easier to mobilize the political support of those groups who were able to escape from poverty through state assistance.

The moral and political dimension is further complicated if economic reform may bring, even if only in the short-run, previously non-poor groups, such as displaced industrial or public sector workers, close to or below the poverty line. These "new" poor are obviously more vocal and better organized and will demand safety nets during reform even if they are less needy. At times, the most politically viable means of reaching the poor may be with programs that simultaneously benefit the "popular" or middle groups of society, who may be losing more during adjustment, than the ultra-poor. Then again, governments will have to make sure that enough resources are available to meet this purpose. Apart from accessing external assistance, developing country governments must enhance their capacities to collect internal revenue, to reduce waste, and to spend efficiently.

Fifth, in addition to being politically difficult, helping the poor is technically challenging. All governments, in whatever society, find it difficult to reach the poor (more so the ultra-poor) effectively. They exist on the margins of society, are unorganized, poorly educated and fed, and hardly articulate. Some of them do not stay put and are frequently mobile. In addition, they are often suspicious of the state and its officials. Thus, even in the presence of a strong political commitment, protecting the poor is difficult. To make things worse, the daunting technical requirements may erode political determination.

This means that only efforts based on careful planning and determined implementation are likely to be effective. Often a starting point is to find out more about the economic and social characteristics of the poor and vulnerable and how they fit into the economy. Only when government can identify the target groups and trace how different policy measures affect them shall it be able to provide effective service and assistance and safeguard against the danger that these same benefits are actually captured by the not-so-poor or even the well-off.

Of course, calls for more research can be used as an excuse to postpone substantive action indefinitely. However, when basic information simply does not exist, it is difficult to see how an effective package of measures to protect the poor can be put in place. The proper approach may be to act on the basis of what we already know while striving to know more so that we can improve on the effectivity of our actions.

And sixth, it may seem paradoxical to prescribe that governments should intervene in the midst of pro-market reforms. But the essence of these government interventions is to help protect the poor and vulnerable so as to enable them to participate in an enlarged and more opportunity-filled market. For freer markets to help the poor, they must be enabled to participate fully in these markets!

Trade liberalization constitutes one of the planks of a difficult economic reform phase. If reliance on a small and insulated technocratic team were sufficient to pursue the earlier stage of stabilization, the current phase involves more complicated and far-reaching institutional changes and requires the mobilization of significant political support. To carry liberalization further, democracies must build political coalitions for reform as well as improve their governance. State capacities must be improved and reforms must show positive results. Reforming democracies must likewise educate the general public and mobilize newly emergent beneficiaries of freer markets. Democratic methods and enhanced state capacities will enable democracies to sustain market reform in the long run. Democracies must end the marginalization of the poor in both the economic and political arenas for market reforms to matter.

NOTES

[1]This reminder comes from Simon Commander and Tony Killick (1988). A good example of policy inconsistency is the imposition of an import levy by the Aquino government, out of a short-run concern for easing public deficits, while in the midst of an import liberalization program.

[2]This apparent irrationality is called the Olson syndrome after Mancur Olson who pointed out that collective or political action is not usually in the interest of any individual belonging to a group even if beneficial to the group as a whole. See Olson (1965) for a fuller discussion.

[3]A total of 32 billion pesos was allocated in the 1995 budget for GATT-related projects especially in agriculture, the sector believed to be hit the hardest by the Uruguay Round agreements. Some 500,000 irrigated hectares and 10,000 kilometers of farm-to-market roads are targeted over the 1995-1996 period. For more details, see Felicito C. Payumo (1994).

[4]Nelson (1992, p. 221) puts in a word of caution here. She made a survey in 1992 of what is known and not known regarding the social costs of economic adjustments in developing nations and the impact of these costs on different socioeconomic groups. She made the frustrating conclusion that there is remarkably little detailed empirical data on these questions. It remains to be seen whether this is the case for the Philippines (though I strongly suspect this is the case). What immediately comes to mind are the studies done by Dean Rene Ofreneo of the University of the Philippines School of Labor and Industrial Relations on the social costs of the 1980 World Bank-financed structural adjustment program on industrial workers. Much of the material on social costs of economic adjustment since then has been produced by NGO "think-tanks."

[5]Bruce Kelley excludes subsistence production, or production from one's own use, from the informal sector. If applied to the Philippine situation, this will most likely exclude a sizable amount of economic activity we would normally classify as belonging to the informal sector.

[6]*Philippine Human Development Report 1994* (Makati: United Nations Development Program, 1994), p. 2; hereafter cited as *PHDR* 1994.

[7]*PHDR* 1994, p. 25.

[8]See also Barbara Stallings (1992).

[9]For a more extended discussion, see Anne Krueger (1993), pp. 75-90.

[10]See Shirley Kuo (1989) for Taiwan and Alice Amsden (1989) for South Korea.

[11]For a more detailed discussion of the GATT-UR provisions on agriculture, see Cristina David (1995), Ramon Clarete (1994a), and Clarete (1994b).

[12]A sample of peasant-sector critiques of GATT-UR include Corinne Canlas (1994), "*Pabi*GATT: NGO-PO Statement on the General Agreement on Tariffs and Trade," and Leonardo Montemayor (1994)—all in *Kasarinlan* 9 (4), 2nd quarter 1994.

[13]"NGO seeks stop to US patenting of tribe genes," *Philippine Daily Inquirer*, June 6, 1996, p. 6.

[14]"WB says RP pro-poor programs are not reaching beneficiaries," *Manila Times*, January 21, 1996.

[15]For a fuller discussion of the contributions and place of Filipino women in the economy, see Solita Monsod (1994).

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COMMENTS

*Rene Ofreneo**

Let me state at the beginning that any discussion of the impact of the Uruguay Round agreements on the economy and the different sectors of society must take into account the effects of the structural adjustment programs initiated in the 80s. The latter contributed to the impetus for globalization.

With regard to the impact of globalization on the informal and the marginal sectors, I think we have to come up with some kind of a framework which does not look at the situation only in terms of winners and losers. Some studies simplistically conclude that when there is globalization, the export sector for example wins and the domestic sector loses. But in reality there are winners and losers in both sectors.

In the export sector, electronics and electrical parts manufacturing are booming but garments and stuffed toys which are included in the Department of Trade and Industry's (DTI's) list of winners have been faltering since 1992. Garments, now a sunset industry, is getting a lot of competition from China, Vietnam, and the South Asian countries. The main reason for the collapse of the local garments industry is that our wages are not competitive. We also have problems with production technology and the sourcing of raw materials like cotton. Our textile industry has no linkage with the garments industry and the turn-around time is much longer.

In the case of traditional industry, it seems that the food industry is booming but I do not know whether this can be attributed to the General Agreement on Tariffs and Trade (GATT)-Uruguay Round. On the other hand, the tire industry has virtually collapsed and so have the shoe and textile industries. Philtread has closed shop and the Marikina shoe industry is a shadow of its old self.

In the case of agriculture, there is a boom in cutflowers, asparagus, rapeseed. Unfortunately, they are planted to a very small area of agriculture. On the other hand, traditional winners like pineapple and banana are having difficulty surviving in the global market. We also have problems in rice, corn, sugar, and the coconut industries. Some of the coconut oil refineries in the country want to import copra from Indonesia.

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What I see is that some of our export and domestic industries are not ready to meet the challenges of globalization and liberalization head on. But I believe that this is not a question of linking or delinking with the global market. It is more a question of defining the terms of incorporation in the global market and getting our acts together.

For example, there is a lot of talk about reengineering and right-sizing—in practice really downsizing. With downsizing, there is what you call the flexibilization of labor or, in lay terms, casualization. We have all kinds of flexible arrangements. There is subcontracting, agency hiring, hiring of apprentices for ten years. Thus, even the small formal labor market is being informalized.

There are three positions in the debate on the ratification of the GATT-World Trade Organization, namely: "GATT forever," "GATT never" and "GATT later". Senator Wigberto Tañada's position is really "GATT later," not "GATT never." And he was raising very valid issues, particularly the issue of how ready are we. It is turning out that some of our agricultural industries are not really ready. In 1994, the projection of DTI was 587,000 new jobs and the projection of the Department of Agriculture was 16 million pesos gross value added a year plus half-a-million new jobs. But to realize these gains we have to work really hard.

I believe we need to do micro analyses, alongside the macro analysis, on the impact of globalization on different industries. The effects are variable and there is probably a need now to focus on adjustments at the industry level. The market can empower the winners as well as disempower the losers and non-participants.

9. Competitiveness, Productivity and Technology

Epictetus E. Patalinghug

INTRODUCTION

A growing body of evidence from developing countries shows considerable differences in the intensity with which industrial technology is used by firms. There is also evidence of inter-firm differences in technological changes by continuing adaptation, incremental improvement, internal development, or learning-by-doing.

The objectives of this paper are: (1) to present the state of current knowledge in this area; (2) to explain the framework for analysis and policy decisions combined with a discussion of policy and research issues; (3) to suggest areas for long-term research; and (4) to identify university-based research programs on competitiveness, productivity, and technology.

Section I of this paper reviews the definitions and the various methodologies of measuring "total factor productivity" or what is equivalent to a measure of technological progress in the economic literature. It cites the various studies on productivity estimation in the Philippines. This section also discusses in detail the empirical evidence on Philippine productivity (both partial and total) as well as the trend in total, agricultural, and industrial productivity. Section II discusses the link between productivity and competitiveness, and explains the factors behind the slow export and growth performance of the Philippines compared to its ASEAN neighbors during the last fifteen years. Section III elaborates on the diverse literature on technology and competitiveness. The relevance of the catch-up hypothesis, technological convergence hypothesis, and the concept of "social capability" are likewise analyzed.

Finally, Section IV identifies the areas for long-term research on "Competitiveness, Productivity and Technology." The areas are broadly classified into three categories: (1) macroeconomic conditions, (2) economic institutions, and (3) organizational and institutional change. Priority research activities are also indicated.

I. RESEARCH ON PRODUCTIVITY GROWTH AND DIFFERENCES

The term "productivity" refers either to total factor productivity (TFP) which denotes the ratio of real output to total real inputs, or to partial factor productivity which pertains to the ratio of output to particular input in real terms (e.g., labor productivity, capital productivity, raw materials productivity, land productivity, etc.). For instance, labor productivity growth is measured as the difference between the rate of increase in output and the rate of increase in labor input (Maddison 1987).

Definition and Methodology

Various productivity studies have been conducted by employing the following methods: (1) productivity ratio approach, (2) growth accounting approach, and (3) production function approach. The choice of a particular approach is guided by the availability of data, area of analysis, dimension of the study, or simply analytical convenience. However, the three approaches are by no means computationally equivalent since each requires a different set of assumptions and different estimating procedures. Nevertheless, the three estimating procedures are actually logically equivalent since a productivity index is always implicit in the production function, while a production function can always be transformed into a growth accounting equation.

Assuming a production relation in which output depends on two factors, namely, labor and capital, then the productivity index approach is symbolically:

$$TFP = \frac{Y_1/Y_0}{(wL_1 + rK_1)/(wL_0 + rK_0)} - 1 \quad (1)$$

where TFP = total factor productivity growth

Y = output

L = labor input

K = capital input

w = wage rate

r = rate of return on capital

The variables with the subscript 1 refer to the current period and those with the subscript 0 refer to the base period. Equation (1) assumes a homogeneous production function and constant returns to scale. This approach requires weighting the real input units by their base period prices to obtain measures of what the inputs of a given period would have produced had their productive efficiency per unit remained the same as in the base period. This approach was pioneered by John Kendrick (1961). In the Philippines, Tirso Paris (1971), Cristina Crisostomo (1972), and Epictetus Patalinghug (1980) have applied this approach.

The growth accounting approach can be represented by the following equation:

$$TFP = \Delta Y/Y - [\alpha(\Delta L/L) + \beta(\Delta K/K)] \quad (2)$$

where α = labor share in output and β = capital share in output.

The growth accounting approach assumes profit maximization, neutral technical progress, and linear homogeneous production function with relative factor prices considered as reasonable measures of marginal products under competitive equilibrium which allows the utilization of factor shares to approximate the relevant coefficients of the production function (Nadiri, 1970; Boskin and Lau, 1992). This approach utilizes the production function as an

accounting format rather than as an estimating framework to quantify the contribution of several factors, including those adjusted for quality change to output growth. Equation (2) implies that the contribution of an input to output growth is equivalent to the rate of growth of that input weighted by its share of output (the production elasticity of output with respect to that particular input). Thus, labor's contribution is equal to $\alpha(\Delta L/L)$, the product of labor's share in output (α) and the rate of growth of the labor force ($\Delta L/L$).

The use of input shares as weights is criticized by some economists as inappropriate when observed earnings and the marginal productivity of labor diverge in markets where wages are determined by social tradition or where wages are determined by administrative order or by legislation. The assumption of competitive equilibrium is likewise criticized because some sectors (e.g., agriculture) may be in continuous disequilibrium (Griliches, 1963); or it may not be adequate for analyzing long-run dynamic processes such as technological diffusion or Schumpeterian competition (Nelson, 1981). The application of the growth accounting approach has been pioneered by Edward Denison (1962), Zui Griliches (1970), and Dale Jorgenson and Griliches (1967). In the Philippines, this approach has been demonstrated by the works of Jeffrey Williamson (1969), Patalinghug (1984), Richard Hooley (1985), Myrna Austria and Will Martin (1992), and Ceasar Cororaton *et al.* (1995).

Basically, the production function approach consists of estimating the following equation:

$$Y_T = F(K_T, L_T, t) \qquad (3)$$

where "t" is a time trend representing the effect of technical progress. This approach is supposed to correct the shortcomings of the growth accounting approach which assumes profit maximization, constant returns to scale and neutral technical progress (Boskin and Lau, 1992).

The advantage of the production function approach is that it can be used to investigate the appropriate algebraic form of the assumed production function. It can also be used to suggest the form of the variables incorporated into the equation. In practice,

however, the assumed methodological superiority of the production function approach is doubtful as the magnitude and the stability of its parameters have not yet been firmly established. Data limitations and the choice of the particular form of the production function are partly responsible for the instability and the inconsistency of its parameters. Nadiri (1970) summarizes the three specific problems as: (1) the fundamental difference between time-series and cross-section input-output relations; (2) the difficulty in distinguishing one production function from another because aggregate data vary in such a narrow range; and (3) statistical problems due to the interdependence and nonlinearity between the production function and marginal productivity conditions.

Also, the limitations of the growth accounting approach apply to the production function approach if the maintained hypotheses of the economic model follow the same assumptions of the growth accounting approach. Solow (1957), Griliches (1963) and Griliches (1964) pioneered this approach. However, a more sophisticated version of this approach was introduced by Laurtis Christensen, Jorgenson and Lau (1973); extended by Lau and Pan Yotopoulos (1989); and recently applied by Boskin and Lau (1992). Less sophisticated versions of this approach were applied in the Philippines by Sicat (1968), Williamson and Gerardo Sicat (1968), Williamson (1971), Patalinghug (1982), Aurora Sanchez (1983), and Cororaton *et al.* (1995).

Measuring Technological Change

The three approaches to measuring productivity assume that the excess in the growth of measured output over the growth of measured inputs generates a "residual." Findings of productivity studies in various countries have found that the growth of output is significantly greater than input growth. The residual is considered a measure of the shift in production function, economies of scale, technological change, advances in knowledge and improved resource allocation. Richard Nelson (1981) calls the residual a "measure of our ignorance and accounts for a hodge-podge of factors."

The magnitude of the residual is sensitive to how inputs are defined. Quality adjustments in the measurement of input quantities have been made in some studies (Denison 1962; and Jorgenson and Griliches 1967). Labor can be classified by education, age, and sex. And capital can be classified into machinery and structures, or by its vintage. Some studies attempt to account for other inputs such as natural resources, energy, and research and development (R&D) spending as separate inputs in order to reduce the size of the residual or "soften the association of technological advance with the residual" (Nelson 1981). Higher estimates of technical progress were observed in studies where no quality adjustments were made. Quality adjustments reduce the contribution of technical progress and increase the contribution of measured inputs. This explains the major differences in estimates of total factor productivity across time for a given country, differences in productivity estimates among countries, and differences in the contribution to growth among various sources.

One of the objections raised by Nelson (1981) against the orthodox literature deals with the assumption of competitive equilibrium which ignores Joseph Schumpeter's and Simon Kuznets' characterization of growth as a disequilibrium process. The other major objection Nelson raised deals with the assumption in most productivity models that technological knowledge is public good, an assumption which runs counter to the findings of some studies (based on evolutionary economics) that stress the important role played by uncertainty in the creation or evaluation of new technology and the existence of differences among firms in technology adopted. Nelson suggests that future productivity studies must depart from the traditional framework that a profit-maximizing firm facing known factor prices is operating in an environment of "widely available technological knowledge."

Research on the economics of technological change must also focus on the effect of uncertainty, incentives and property rights on the relationship between R&D and productivity growth. Another area where a new direction in productivity research needs some reorientation deals with the role of economic environment and political and social institutions in enhancing the complementarity among the three sources of growth, namely: capital accumulation, education, and technological progress.

The Sources of Productivity Growth: The Philippine Evidence

Productivity estimates derived from Philippine studies utilizing one or all of the three methodological approaches discussed earlier in this paper are shown in Tables 9.1 to 9.5. Table 9.1 shows Hooley's (1985) productivity estimates for the manufacturing sector by subperiods. Hooley's study shows a decline in total factor productivity by 0.15 percent per year from 1956 to 1980. Hooley explained that the decline in total factor productivity cannot be attributed mainly to "inefficient resource allocation among industries" as Williamson and Sicat (1968) have suggested. In addition to the inter-industry shift factor, Hooley identifies the following factors as equally significant in explaining the decline of total factor productivity in Philippine manufacturing from 1956 to 1980: (1) the significant expansion of government-owned and controlled corporations; (2) the sharp rise in oil prices, fuel shortages and power "brownouts;" (3) the miscalculation by businessmen of the duration and magnitude of the decline in output spurred by the recession of 1975-1978; (4) the increased centralization of economic decision-making (which encourages managers and workers to ingratiate themselves with and entertain top decision-makers instead of engaging in efficiency-raising activities); and (5) the absence of research and development in industry despite windfall gains from the commodity boom during 1972-1974 (Hooley, 1985).

One of the policies affecting the decline in total factor productivity was the tariff policy on import that reduced the prices of inputs by five to 10 percent between 1956 and 1969. This made input prices too cheap compared to their world market levels. Expectedly, raw material productivity declined by 1.36 percent per year for the period 1956-1980 (Hooley, 1985).

From the perspective of this paper, the lack of R&D activities during the import-substitution phase of Philippine industrial growth runs counter to the experience of the successful Japanese firms in the VCR industry which adopted a long-term horizon and successfully developed their competitive edge through technology (Morone, 1989).

Table 9.1 Annual growth rates in partial and total factor productivity in Philippine manufacturing, 1956-1980 (in percent)

	1956-60	1961-65	1966-70	1971-75	1976-1980	1956-80
Output per unit of:						
Labor	5.55	3.27	4.87	0.59	-4.04	2.05
Capital	0.78	2.95	2.89	1.37	2.72	2.15
Intermediate goods	-0.51	-2.58	-0.26	-1.50	-1.86	-1.36
Total factor input	1.18	-0.71	1.22	-0.55	-1.90	-0.15

Source: Richard Hooley, "Productivity Growth in Philippine Manufacturing: Retrospect and Future Prospects," PIDS Monograph Series No. 9 (December 1985).

Another issue raised by Hooley's study was the implementation of an inappropriate industry targeting policy that favored poorly performing capital-intensive industries (e.g., petroleum, iron and steel, industrial chemicals) instead of exploiting the efficiencies of labor-using import-substituting industries (e.g., food processing, beverage, tobacco, apparel). According to Ponciano Intal, Jr. (1991), the Philippines followed the Latin American path of economic development by shifting from the first stage of import substitution (focused on nondurable consumer goods) to the second stage of import substitution (focused on consumer durables, intermediate goods, and capital goods). In contrast, the Asian newly industrializing countries or NICs (Hongkong, Singapore, South Korea and Taiwan) moved rapidly from the first stage of import substitution to the first phase of export orientation (primarily based on labor-intensive manufactured exports). All of these NICs are now firmly at the second phase of the export-oriented strategy (primarily based on capital- and technology-intensive manufactured exports).

Table 9.2 presents a cross-section of studies on productivity growth in Philippine manufacturing. The studies by Hooley (1985) and Cororaton *et al.* (1995) show that total factor productivity can be attributed more to technical efficiency than to technological progress. The former refers to the movement from current practice to best practice in the industry. The latter refers to the movement of the technological frontier over time in terms of developing new technology; acquiring new technology from abroad through licensing and technical agreement; or adapting new or improved technology embodied in new equipment through reverse engineering, learning-by-doing, or imitation. The limited evidence on Philippine manufacturing consistently points to the failure of Philippine industries to consider the technology factor in achieving long-run competitive advantage. The evidence indicates that at best even if some industries are moving toward "best-practice" according to the industry, the "best-practice" itself is way below the best in international standards.

One of the disappointing realities in Philippine productivity research is that although the first hypothesis researchers want to investigate is the empirical relationship between R&D expenditure and productivity, the data series (aggregative or firm-level) on R&D expenditures are either poor or nonexistent. For instance, Hooley's

Table 9.2. Annual rates of growth of input, output, and productivity in Philippine manufacturing (in percent)

Author(s)	Time Period	Capital	Labor	Intermediate Inputs	Technological Progress	Technical Efficiency	Output
Sicat (1968)	1957-1962	11.4	5.9	NA	1.1	NA	10.9
Sicat (1968)	1960-1965	4.4	6.6	NA	2.4	NA	7.6
Patalinghug (1980)	1956-1970	6.1	5.4	NA	3.5	NA	9.5
Hooley (1985)*	1956-1970	1.9	2.5	6.5	-0.74	-0.18	10.2
Hooley (1985)*	1971-1980	1.1	2.3	5.5	-2.3	-0.30	6.6
Cororaton, *et al.* (1995)*	1956-1992	1.4	0.97	2.5	-1.7	2.5	5.6

Source: Derived from cited studies.

* Refers to contribution to growth (decline) in percentage points; growth rates weighted by relative factor shares.
NA - not available

valiant attempt (1985) to specify R&D in his productivity regression equation produced the expected positive coefficient but the estimate was not statistically significant. The same result was experienced by the study of Cororaton *et al.* (1995). In Hooley's case, R&D was defined alternatively as: (1) the number of patents applied for in the Philippine Patent Office (compiled by industry), and (2) the compilation of research work done for others by industry. Neither variable captures the informal R&D activities of many small enterprises (Hooley, 1985; Ranis, 1995). The disappointing state of data in this area is summarized by the following statement: "Hopefully, at some future date, there will be actual data on the value of R&D expenditures by industry" (Hooley, 1985, p. 49). But data availability has not improved.

Table 9.3 presents estimates on productivity studies in Philippine agriculture. In all these studies covering the period 1948-1974, output growth in Philippine agriculture did not exceed five percent even in those periods when land was still plentiful. On the other hand, expenditures on current inputs (e.g., fertilizer, agricultural chemicals, seeds, irrigation services) were growing rapidly during periods when land-man ratios were relatively higher (e.g., 22.5 percent in 1948-60 compared to 9.2 percent in 1960-67). The vanguard sector of the Philippine economy was relying more on input growth (particularly on increase of capital input, both fixed and current) to boost the agricultural output growth performance during this period. The contribution of agricultural productivity was inferior to the contribution of measured inputs. But the performance of agricultural productivity was better if compared to the performance of manufacturing productivity.

Table 9.4 shows a cross-section of productivity studies that identify the contribution of the different sources of Philippine economic growth. In percentage points, the contribution of productivity from 1947 to 1982 ranges from 15 to 55 percentage points. However, a recent study (Austria and Martin, 1992) covering the period 1950-1987 produced a negative residual: i.e., the weighted contribution of measured inputs exceeded the growth of national output. One study (Patalinghug, 1984) made quality adjustments to the labor input and quantified the contribution of education to economic growth during

Table 9.3. Annual rates of growth of input, output, and productivity in Philippine agriculture (in percent)

Author(s)	Time Period	Capital	Labor	Land	Operating Expenses	Productivity	Output
Paris (1971)	1948-1967	13.3	3.1	7.4	16.8	0.4	4.2
Paris (1971)	1960-1967	10.9	3.0	6.3	9.2	-0.1	3.0
Crisostomo (1972)	1957-1967	4.9	2.1	1.1	6.2	1.7	3.7
Crisostomo (1972)	1948-1967	6.8	2.5	2.5	10.0	1.1	4.1
Patalinghug (1980)	1956-1970	5.1	0.9	5.6	NA	2.1	5.2
Patalinghug (1980)	1956-1974	5.4	-0.9	3.1	NA	1.5	3.1

Source: Derived from estimates of cited studies.

NA not available

Table 9.4. Contributions of the different sources of Philippine economic growth (in percent)

Author(s)	Time Period	Capital	Labor	Land	Education	Technological Progress	Total	GDP
Williamson (1969)	1947-1955	9	33	3	NA	55	100	7.3
Williamson (1969)	1955-1965	25	54	5	NA	15	100	4.5
Sanchez (1983)	1960-1973	24	52	NA	NA	24	100	4.6
Patalinghug (1984)	1960-1982	48	23	NA	6	23	100	5.5
Austria and Martin (1992)	1950-1987	87	24	NA	NA	-11	100	4.6

Source: Caesar B. Cororaton, Benjamin Endriga, Derrick Ornedo, and Consolacion Chua, "Estimation of Total Factor Productivity of Philippine Manufacturing Industries: The Estimates," Discussion Paper No. 95-32, Philippine Institute for Development Studies (November 1995).

GDP gross domestic product
NA not available

the 1960-1984 period at six percentage points. These studies assumed the additivity of the different sources of growth. This brings us to the point raised by Nelson (1981) that "where complementarity is important, it makes little sense to try to divide up the credit for growth, treating the factors as if they were not complements" (p. 1053). Thus, if new capital embodies advanced technology that requires a highly educated technical manpower, it makes little sense to decompose the contribution of education, technological advancement, and capital accumulation to growth.

Table 9.5 presents a comparison of productivity performance between the Philippines, Taiwan and South Korea. The following pattern is discernible. First, in the Philippines the average annual growth rate is at best half those of Taiwan and South Korea. Second, in the Philippines the growth in measured inputs largely contributes to the growth in real output, but in Taiwan and South Korea output growth is largely accounted for by the growth in total factor productivity. And third, the absolute growth rate of productivity in Taiwan and South Korea is three times and five times that of the Philippines, respectively.

Raul Fabella (1993) explains this situation as the predicament of "inward orientation [that] leads to low investment growth and low investment growth leads to low productivity and poor competitiveness" (p. 10). But Paul Krugman (1994b) challenges the World Bank view (1993) that the high-performing Asian economies (HPAEs) are fueled by high productivity growth. He thinks the "East Asian miracle" is a myth because growth in measured inputs (investment flows) rather than growth in productivity artificially fueled their rapid growth. This is reminiscent of the Soviet strategy in the 1960s and 1970s. But some studies argue that while the extensive growth strategy led to eventual stagnation in the Union of Soviet Socialist Republics (USSR), the same strategy sustained rapid growth in the HPAEs. Nevertheless, even if total factor productivity growth is accepted as the engine of growth in the HPAEs, rising capital-output ratios in East Asia are clearly observed (Easterly and Fischer, 1995). While more investment flows are better than less investment flows, sustainable growth is not guaranteed unless the complementarities of capital investment and technological advancement are demonstrated.

Table 9.5 Contribution of real factor growth and total productivity growth to growth of real output (average annual growth rates)

	Philippines (1960-1969)	Taiwan (1960-1969)	South Korea (1960-1973)
Real output	0.044	0.089	0.097
Real factor input	0.031	0.044	0.055
Total factor productivity	0.013	0.045	0.066

Source: Raul Fabella, "Efficiency and Competitiveness: The Role of the Exchange Rate," PHILEXPORT/ PITO-P Policy Paper (November 1993). These figures were derived from Aurora Sanchez's (1983) study.

II. PRODUCTIVITY AND COMPETITIVENESS

International competitiveness is the favorite industrial policy topic in this era of global competition. Krugman (1994a) admonished everyone to avoid pursuing the confusing issue that a country has to be productive in order to compete in the global economy. In Krugman's words, "productivity and competitiveness have very little to do with each other... a country whose productivity is low across the board is not going to have a high standard of living; but that has nothing to do with the fact that it must coexist with more productive nations... low productivity relative to other countries is not only not a disaster; it is irrelevant... Productivity is important, but international competitiveness has nothing to do with it ... the whole concept of competitiveness is at best elusive, at worst meaningless" (pp. 269-280). The study of Cororaton *et al.* (1995) where the regression coefficient of the international-competitiveness variable on productivity was not significant, supports Krugman's hypothesis. On the other hand, Alice Amsden (1989) has insisted that the creation of Korean competitiveness in steel depended on higher productivity instead of lower wages.

Let us turn to the various issues affecting Philippine competitiveness. Fabella (1993) contends that competitiveness is attained by a cheap-peso policy. But impediments to devaluation-induced competitiveness exist. In another study using indices on revealed comparative advantages, Intal (1991) documented the deterioration of Philippine competitiveness in the 1980s. He appropriately analyzed the role of labor productivity, real exchange rate, and infrastructure in the country's poor export and growth performance. Intal's analysis of the productivity and exchange-rate factors affecting Philippine export performance is shown in Tables 9.6 and 9.7. Table 9.6 shows that in terms of trends in labor productivity, the Philippines lags behind all countries shown, except for trends in agricultural productivity with respect to Indonesia and Thailand. Table 9.7 shows that China and Indonesia followed a devaluation-induced competitiveness policy that made its exports more price-competitive *vis-à-vis* Philippine exports. This analysis points to the need for economic policy reforms to improve the country's international competitiveness.

Development Alternatives, Inc. or DAI (1991) data on indices of output per worker by industry in selected Asian countries are shown in Table 9.8. One way of looking at this data is to conclude that Indonesia is gaining *vis-à-vis* the Philippines in such areas of manufacturing as textile, apparel, footwear, wood, furniture, printing, glass, and electrical machinery. Another interpretation of Table 9.8 especially for firm managers is that attaining international competitiveness is still possible despite the lack of a stable macroeconomic policy, rising wage rates, an overvalued exchange rate, and low national productivity. However, a firm must find a competitive factor to succeed in a tilted playing field.

Morone (1993) has argued that globally competitive United States firms have built global leadership through technology. The World Bank (1993) has attributed the so-called rapid productivity growth among HPAEs to better technology, innovations on the shop floor, gains from specialization, and better organization. But empirical estimates of technical efficiency change show that Indonesia, South Korea, Malaysia and Singapore did not shift rapidly from average practice to best practice. Cristopher Freeman (1994) has indicated that the World Bank (1993) study "denies any role to

Table 9.6. Indices of average labor productivity for selected Asian countries, 1975-1990 (1975=100)

Country	1975	1980	1985	1990
China				
Overall	100	122	166	203
Indonesia				
Overall	100	126	131	140
Agriculture	100	117	121	113
Manufacturing	100	156	195	227
Malaysia				
Overall	100	125	138	163
Agriculture	100	133	159	182
Manufacturing	100	104	117	161
Philippines				
Overall	100	120	96	104
Agriculture	100	119	115	123
Manufacturing	100	122	107	119
Singapore				
Overall	100	116	147	187
Agriculture	100	114	219	265
Manufacturing	100	114	136	189
Thailand				
Overall	100	118	136	167
Agriculture	100	101	116	118
Manufacturing	100	121	131	165

Source: Ponciano Intal, Jr., "Taking the Flying Wild Geese to Heart: Economic Policy and Industrial Restructuring Challenges for the Philippines in the 1990s."

Table 9.7. Real effective exchange rate indices for selected Asian countries, 1975-1990 (1975=100)

Country	1975	1980	1985	1990
NICs				
Hongkong	100	110	93	82
South Korea	100	105	105	80
Singapore	100	111	103	101
Taiwan	100	110	93	82
ASEAN-4 and China				
Indonesia	100	141	126	239
Malaysia	100	125	109	129
Philippines	100	99	101	112
Thailand	100	109	113	115
China	100	116	195	215
South Asia				
Bangladesh	100	132	146	123
India	100	130	129	161
Pakistan	100	115	134	176
Sri Lanka	100	260	221	261

Source: Ponciano Intal, Jr., "Real Exchange Rates, Price Competitiveness and Adjustment in Developing Asia, 1975-1990" (March 1992).

active industrial and technology policies and has little to say about new technology" (p. 213). A research study on productivity, technology and competitiveness must veer away from aggregate and country studies. Instead it must emphasize how industrial R&D and technology upgrading (e.g., electronic industries in South Korea, Singapore, and Taiwan) were complemented by a system of innovations that allowed these tigers to achieve a remarkable catching-up performance.

Table 9.8. Indices of the level of output per worker by industry in selected Asian countries, 1986 (Singapore = 100)

	Indonesia	S. Korea	Malaysia	Philippines	Singapore	Thailand
All Manufacturing	60.68	127.96	50.97	86.06	100.0	63.27
Food	45.23	145.24	59.73	116.23	100.0	64.37
Beverage	59.60	176.74	57.39	120.37	100.0	101.05
Tobacco	31.01	599.34	117.07	160.94	100.0	81.21
Textile	68.50	153.07	54.68	41.37	100.0	42.69
Apparel	99.81	183.07	56.87	64.61	100.0	56.66
Footwear	207.47	239.01	92.55	51.41	100.0	-
Wood	126.11	134.12	53.69	46.75	100.0	15.66
Furniture	70.96	195.37	61.16	41.12	100.0	-
Printing	66.91	157.27	50.24	42.58	100.0	32.74
Chemicals	45.29	95.94	115.44	89.37	100.0	30.60
Rubber	55.19	100.02	77.72	76.71	100.0	110.21
Glass	160.22	179.20	69.68	80.77	100.0	38.81
Machinery	62.67	155.86	46.38	43.19	100.0	41.80
Electrical	94.73	152.63	51.23	76.24	100.00	69.88

Source: Development Alternatives, Inc, "Philippine Trade and Investment Regimes: A Comparison with Asian Neighbors" (December 1991), Table 31, p. 79.

III. TECHNOLOGY AND COMPETITIVENESS

The Japanese historical experience has been suggested to be particularly relevant to many Asian countries because Japanese efforts to bring about a rapid transfer of western technology at the beginning of the Meiji period were undertaken under conditions of scarce capital and natural resources (Rosenberg, 1990). The Japanese experience also called attention to the problem faced by innovating firms today, particularly the need to assess alternative technology available in the market:

> *In the Japanese case, the need to adapt foreign technology to domestic circumstances was not at first understood. Dutch water control technology, for instance, was introduced without considering that, in addition to*

> *tidal forces, mountain run-off was a major source of flooding. Similarly, the Japanese government in 1871 imported a huge mechanized silk reeling plant from France. While it was intended as a model factory, private business discovered that it could not profitably operate such capital-intensive plants* (Rosenberg, 1990, p. 152).

The Japanese subsequently learned from their initial mistakes. Moreover, they recognized the firm as the focal point, if not the major player, in the process of technology transfer. In many countries trying to embark on a technological catching-up, several research laboratories are set up but they are not matched by technological capabilities in firms themselves. In India, Nalthan Rosenberg (1990) analyzed the failure of the Council for Scientific and Industrial Research (CSIR) to have any discernible impact on the productivity and efficiency of the industrial sector as a result of the detachment from market needs of Indian firms. This Indian case illustrates not only the importance of building up the educational, scientific and research infrastructure but also the need to improve the effectiveness of the adoption and commercialization of new technologies. In addition, the objective of encouraging the development of technological capabilities within firms is consistent with the experience of technologically-advanced countries where technology emerges mainly from corporate research and development (although it is highly dependent on academic research). Technology importation is not simply the purchase of production inputs and the licensing of production know-how. It also requires a strong capacity for reverse engineering, including shopfloor tinkering of small entreprise.

The role of private sector R&D as opposed to public sector R&D in the case of South Korea is illustrated in Table 9A.1 (see *Appendix*). Private sector R&D expenditures are four times higher than that of public sector R & D. In addition, both Japan and South Korea's R&D systems have been changing in response to changes in the technological and competitive environment. Table 9A.1 likewise shows South Korea's efforts at achieving a rapid technological catching-up. The percentage of gross national product (GNP) allocated to R&D expenditures in 1993 is close to the levels of R&D investment observed in Japan, Germany, and the United States. The dominant role of

corporate R&D in South Korea is shown in Appendix Table 9A.2 which indicates that R&D expenditures in national and public institutes are three times the R & D expenditures in universities and colleges.

In Appendix Table 9A.3, the dominant role of federal sources in support of basic research in the US is shown. The percentage of government R&D in the US reached 67 percent in 1963 (see Mowery and Rosenberg, 1989) and declined to slightly below 50 percent thereafter. Thus, South Korea and the US assigned different roles to the private sector in their respective R&D systems. Since US R&D is heavily geared toward military purposes, a greater government role has been observed. But the declining spillover effects of military R&D to civilian and commercial uses have led analysts (Thurow, 1992) to conclude that US civilian R&D expenditures as percent of gross national product (GNP) are falling behind those of Japan and Europe.

One of the objectives of the research agenda discussed in the next section is to determine where our firms and industries stand in the technology game. We need to assess where we stand in terms of the following technologies: data-based systems, biotechnology, advanced materials, design and engineering tools, pollution reduction, software, computers, portable communications equipment, chip-making equipment and robotics, electronic packaging, flat-panel displays, materials processing, optical storage, manufacturing processes, superconductors, voice recognition and vision in computers, microelectronics, and magnetic information storage. The comparison must be made in terms of the country groupings in Table 9.7. In addition, the country's position *vis-à-vis* the technology-frontier countries (e.g., Germany, Japan and the United States) must likewise be assessed. In this way, it is possible to report that the country is ahead *vis-à-vis* Pakistan, at par with Indonesia, but far behind South Korea, Taiwan, Japan, and the US in terms of design and engineering tools. This kind of research information is valuable if we are to assess where we stand and how far behind we are in each of the leading edge technologies. It will also help us determine what needs to be done to make possible a rapid technological catch-up.

The framework for assessing the historical trends in the growth of industrial research must start with the Department of Science and Technology's research on total employment, scientific personnel,

research intensity, and employment concentration in Philippine manufacturing classified by industry. The aim is to evaluate the laboratory foundations, rather than simply employment, in the different manufacturing industries. The hypothesis is that rapid expansion in a given industry can be attributed to its scientific investments or laboratory foundations in earlier periods. We need to verify the applicability of this hypothesis to the Philippine experience.

The catch-up or convergence hypothesis (Abramovitz, 1986) asserts that "in comparisons across countries the growth rates of productivity in any long period tend to be inversely related to the initial levels of productivity " (p. 386). This hypothesis implies that the larger the technological or productivity gap between Japan and the Philippines, the stronger the Philippines' potential for growth in productivity and the faster the expected growth rate of the Philippines. William Baumol (1986) has provided empirical support for the convergence hypothesis thus: *"There is no more substance to the view of many noneconomists that a persistent lag in a nation's productivity growth will place it at a competitive disadvantage in international trade, excluding it increasingly from export markets, with devastating effects upon its export industries and its balance of payments"* (p. 1083).

There has been considerable debate in the economic literature on the validity of the convergence hypothesis. Baumol (1986) has argued that the convergence of national productivity levels and per capita income levels is apparent in industrialized market economies but not in less developed countries. Bradford De Long (1988) has demonstrated that adjusting for sample selection bias in Baumol's methodology yields no convergence. Baumol and Edward Wolff (1988) acknowledged using an "inadvertently biased" sample in showing a convergence of national productivity levels and per capita income levels among industrialized countries, but insisted that convergence indeed emerged, although the story is more complex than they thought. Baumol, Sue Ann Batey Blackman and Wolff (1989) and Williamson (1991) have clarified the facts behind the convergence hypothesis: there is no simple formula on how a country achieves membership in the "convergence club."

In Abramovitz's (1986) analysis, the catch-up or convergence hypothesis is not this simple. It has to be qualified because "technological backwardness is not usually a mere accident." An adequate "social capability" is required for a technologically-backward country to absorb advanced technologies. Rapid realization potential requires strengthening the educational, institutional, and organizational components of "social capability." These involve higher levels of general and technical education; greater experience with large scale production, distribution and finance; openness to competition; openness to the establishment and operation of new firms; openness to the sale and purchase of new goods and services; broad scientific bases; a well established connection of science, technology and industry; and an effective legal system. The social capability components that facilitate the diffusion of knowledge and the rate of investment will determine the pace of the technological catch-up experience (Abramovitz, 1986). Social capability likewise encompasses a country's "political institutions, its political integration and the effective consensus in favor of development" (Abramovitz, 1990, pp. 2-3).

Erik Reinert (1994) explained that underdevelopment can be understood by analyzing the consequences of being a low technology nation. On the other hand, Sanjaya Lall (1992) identified inappropriate government policies and weak political leadership as major hindrances to building technological capabilities.

In analyzing the process of technological change in the US machine tool industry in the 1840-1910 period, Rosenberg (1963) observed that common processes and problems in the production of a wide range of disparate commodities (e.g., firearms, sewing machines, bicycles, and automobiles) occurred. Thus, the technological bases in the production processes of different industries were closely related. Rosenberg (1963) called this phenomenon "technological convergence." Abramovitz's concept of "social capability" and Rosenberg's concept of "technological convergence" are mutually reinforcing and relevant to less developed countries in general and to the Philippines in particular. Morone (1993) showed that globally competitive Japanese firms (those using the technology edge) are concentrated in consumer electronics, liquid crystal display, microelectronics, copiers, computers, telecommunications,

machine tools, robotics, automobiles, and scientific or precision instruments. One of the objectives of future research in this area would be to investigate whether the Japanese experience or even the South Korean experience is a confirmation of the validity of Rosenberg's concept of technological convergence.

Economists disagree on what policies are needed to achieve technological and economic development. The World Bank (1993) and Krugman (1994) have shown that the policy of industrial targeting is not an effective tool for achieving economic development. On the other hand, Amsden (1989) has strongly argued for the appropriateness of implementing an industrial targeting policy to hasten technology transfer and achieve faster catching-up. However, most of the literature on technological transfer ignores the learning-by-doing of production workers (Nilsson 1995) or what is called "skill innovation" in the literature.

Even if industries are tradition-bound, catch-up strategies can still be effective as long as markets are open and resources are mobile (Nelson and Wright, 1992). David Teece (1992) suggested an analytic approach for innovators in analyzing new market opportunities to avoid a situation "where firms were first to commercialize a new product but did not participate in the profits that were subsequently generated from the innovation" (p. 175).

Based on our literature review, the "leapfrogging strategy" suggested by Serafin Talisayon (1994) for the Philippines would be misplaced if Abramovitz's concept of building "social capability" is not addressed first. Lall's suggestion (1992) that misguided government intervention and the political weakness of the policy market expose government selective industrial policies to "hijacking" by vested interest is nothing new. What is more appropriate is to assess whether the new policy of the Board of Investments to require the use of brand new equipment in at least twenty-one sectors (see "BOI Requires Brand New Equipment in 21 Sectors," *Manila Bulletin*, January 7, 1996) is consistent with one of the research topics identified in the next section. Does investment in new technology improve productivity? Or are innovating firms limited to large firms (Pavitt, 1992) that satisfy certain characteristics?

IV. AREAS FOR FURTHER RESEARCH

Classification of Current Research

After a cursory review of current knowledge in this area, the various studies can be classified into three major areas: (1) macroeconomic conditions; (2) economic institutions; and (3) organizational and institutional change.

Research under the first category analyzes the link between inflation, unemployment, exchange rate, investment and productivity growth. The second category encompasses research areas in industrial economics. Some examples are: (1) the influence of the regulatory environment on decision-making regarding R&D and capital investment, (2) the role of engineers and scientists in carrying on R&D, (3) the relationship between education and industrial productivity, (4) intra-industry productivity differences among firms, (5) the relationship between R&D spending and technological advance, (6) the impact of government research in instituting agricultural and/or industrial productivity, and (7) patents, property rights, R&D spending and productivity. The third category covers a broad research area traditionally of interest to sociologists, psychologists, organizational theorists and institutional economists. Examples of research undertaken in the area are: (1) incentive pay schemes and worker productivity; (2) professional management and organizational performance; (3) organizational innovation and firm productivity; (4) morale, loyalty, and worker productivity; (5) unionism and technological change; (6) the structural conditions needed for an industry to support considerable R&D and to conduct it efficiently; (7) internal organization, access to technology, and productivity; and (8) comparisons of innovating firms and laggers in terms of growth rates.

Proposed Research Agenda

The first priority for future research is to undertake integrative studies of past and current research. For instance, an integration of the work by macroeconomists with the studies done by

psychologists, sociologists, and organizational theorists would be very useful. Furthermore, it does not require the conduct of a new and duplicative study.

To have an optimum payoff, a future research program on "Competitiveness, Productivity and Technology" must focus on explaining inter-firm, inter-industry, and intra-industry productivity differences. These issues are covered under the second and third categories of research discussed in the preceding section. These research topics can be pursued by identifying selected industries, say eight to ten industries, and conducting the study following the scope and organizational framework of the study *Made in America: Regaining the Productivity Edge* conducted by the MIT Commission for Industrial Productivity (see Dertouzos *et al.* 1989).

This menu of research issues would help us address some of the existing knowledge gaps such as: What explains differences in levels and rates of change in productivity among firms and industries? What is the contribution or the influence of technology in achieving this performance? How are risks and uncertainties treated in managerial decision-making for firms that undertake R&D activity to create a competitive niche in the market?

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APPENDIX

Table 9A.1. South Korean R&D expenditures by sector, 1989-1993 (in million dollars)

Year	Public Sector (%)	Private Sector (%)	Total (%)	% of GNP
1989	718 (20)	2,803 (80)	4,146 (100)	1.90
1990	814 (19)	3,333 (81)	4,676 (100)	1.88
1991	1,020 (20)	4,178 (80)	5,466 (100)	1.94
1992	1,098 (18)	5,138 (82)	6,328 (100)	2.09
1993	1,295 (17)	6,320 (83)	7,615 (100)	2.33

Source: Ministry of Science and Technology, Republic of Korea, Science and Technology in Korea, 1995.

Table 9A.2. South Korean: R&D expenditures by research institute, 1989-1993 (in million dollars)

Year	National & Public Institutes (%)	Universities & Colleges (%)	Private Companies (%)	Total (%)
1989	746 (18)	332 (8)	3,068 (74)	4,146 (100)
1990	1,029 (22)	327 (7)	3,320 (71)	4,676 (100)
1991	1,203 (22)	383 (7)	3,380 (71)	5,466 (100)
1992	1,329 (21)	380 (6)	4,619 (73)	6,328 (100)
1993	1,599 (21)	533 (7)	5,483 (72)	7,615 (100)

Source: Ministry of Science and Technology, Republic of Korea, Science and Technology in Korea, 1995.

Table 9A.3. United States sources of funds for basic research by sector, 1975-1984 (in million dollars)

Year	Total	Federal Government	Industry	Universities & Colleges	Other Non-Profit Organizations
1975	4,608	3,139	705	478	286
1976	4,977	3,436	769	475	297
1977	5,537	3,823	850	527	337
1978	6,392	4,445	964	605	378
1979	7,257	4,044	1,091	711	411
1980	8,039	5,559	1,265	805	460
1981	9,217	6,236	1,585	909	487
1982	9,886	6,588	1,805	983	510
1983	10,610	6,970	2,025	1,075	540
1984	11,850	7,775	2,270	1,220	585

Source: David Mowery and Nathan Rosenberg. *Technology and the Pursuit of Economic Growth.* Cambridge: Cambridge University Press, 1989.

COMMENTS

*Linda Posadas**

As a sectoral planning council, the Philippine Council for Advanced Science and Technology Research and Development (PCASTRD) is concerned with building up local capability in advanced science and technology. PCASTRD has a mandate to develop, coordinate and integrate a national R & D system in the advanced science and technology sector. That means planning and allocating very limited resources for putting up the educational, scientific and research infrastructure in advanced science and technology. Such local capability as articulated in Dr. Epictetus Patalinghug's paper is indeed necessary to ensure that we can correctly appraise foreign technologies and make sound decisions on whether or not to import and adapt them.

In trying to fulfill the mandate of the Council, we have to frequently grapple with questions and problems such as how to determine or quantify the contribution of R & D and investments in S & T education and manpower development to total productivity and technological competitiveness. In other words, how effectively are investments in R & D and education being translated into wealth? This is especially important when we appear before Congress to defend our budget proposals. We are almost always asked to discuss how R & D investments will boost the number of jobs available in the country and so on.

How should we allocate limited R & D resources among the different areas of high technology? Do we give more R & D money, for example, to material science which in the country is in its infancy, or do we give it to biotechnology which is almost at the threshold of commercialization? How does basic research drive productivity growth, and if so what is the appropriate mix of basic and applied research that will yield the best results for us? How do we benchmark the performance of our own R & D institutions as well as our national technological capabilities relative to the state of the art? We would also like to have some model on the proper valuation of failed research. Surely there is some value obtained even if a research fails.

These are very real questions that we have to grapple with. The answers may be very elusive but we need them if we are to do our work well. So we would certainly appreciate research that would give us theoretical models to study and maybe try out using our data.

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* Executive Director, PCASTRD, Department of Science and Technology

Making matters more difficult for our work in the Council are a number of existing conditions in the country that affect S & T development planning and capability building. Our social and legal systems have been outdistanced by technological advancement. For example, experiments in biotechnology and genetic engineering have gone ahead even as biosafety regulations are still pending in Congress. Another example is the adoption of DNA technology for forensic work. The National Bureau of Investigation (NBI) has procured equipment for this even in the absence of a legal framework on the acceptability of DNA testing as evidence. What is more, the population genetic database which is essential as reference to accomplish positive identification is nonexistent! These are just a few examples of how our legal and social institutions are being left behind by the rapid pace of technological development.

Another situation that prevails in the country which also poses difficulties in the fulfillment of the Department of Science and Technology's (DOST's) mandate is that our private sector still hesitates to take risks inherent in R & D. They would rather seek improvement in their productivity through legislative measures and the regulatory environment in general. For example, they would rather ask for tax incentives or wage controls rather than innovate or do upstream R & D. In fact, DOST makes available R & D funds to the private sector as long as they are willing to shoulder 70 percent of the total cost. However, the response from the private sector is rather cool and there have been cases when the Philippine Council for Industry, Energy, Resource and Development (PCIERD) had to beg the private sector to submit proposals so that the money would be used.

There is one other factor. Our researchers, especially the older ones, are still not used to handling large-scale R & D projects. For a long time, they had to make do with a 30,000-peso research budget. Now that the ceiling has been raised to a few millions, they have some difficulty conceptualizing and implementing big budget programs and integrating the multisectoral, multidisciplinary and interagency collaborative aspects of research work.

I have only two reactions to some of the items brought up by Dr. Patalinghug on the R & D variables being used in current studies. The listed ones are actually the same ones being monitored by DOST essentially because these are UNESCO-prescribed. Other countries use the same indicators for purposes of comparison. But some new technology indicators have been designed and defined by the Oslo Manual arising out of an OECD conference. These include such indicators as the technology balance of payments, innovation index and so on. Finally, I would like to cite a study by Dy (1996) on the relationship between total factor productivity growth and R & D among 12 chemical firms because certain findings of the study address some of the questions raised by Dr. Patalinghug.

COMMENTS

*Serafin Talisayon**

When I first read the paper of Dr. Epictetus Patalinghug, I felt depressed. The paper is very good but the picture it painted of what has happened during the last 40 to 50 years is really depressing: the opportunities that we lost, the policy mistakes, the decline in total factor productivity by 15 percent from 1956 to 1980 due largely to misguided policy and other factors. The problem is not so much lack of investments (in itself a problem) but wrong policies. So, the challenge is how to correct policy with exercises such as this conference hosted by the University of the Philippines-Center for Integrative and Development Studies (UP-CIDS). In that regard, I have one criticism to make. The recommendation of Dr. Patalinghug is more research. But I think the solution is to come up with a program of action that is on the right track. Maybe we can address both areas by saying that we need more policy research. I would like to see results in terms of policy recommendations that the government can implement immediately. Otherwise, we will have another 50 years of very depressing performance.

I will move on to my second favorite topic: research and development. Right now you will notice that most of the decisions of government are based on the assumption that to push growth, all we have to do is simply bring in more investments. While this is true, Singapore for example is targetting not only investment-led growth but also what we may call R & D-led growth. Now moving from the first to the second is to me a very big challenge. How do we do that? How do we link the scientific community to the industrial structure? We spend hardly two percent of gross national product (GNP) on R & D. So we have to increase R & D spending. I do not think it is necessary to do any macroeconomic modelling to understand and realize that R & D is very important for productivity because we will only be bogged down with measurement problems. We already know that R & D is very important. So the question is, how do we deepen R & D?

Dr. Linda Posadas mentioned something about failed research at DOST. I have a hunch about what could be the problem here. The topics of most of the researches funded by DOST during the last decade have been identified not by the industrial sector but by

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* Deputy National Security Adviser

academe. In fact, the five research councils she mentioned are manned by individuals who are from the academe. The upper level of the bureaucracy comes from academe. On the other hand, industry also has its own faults. It has what I might call a US catalogue mentality. When industry needs a technological solution it does not go to DOST or to the academe or to a Filipino scientist; it looks at a catalogue. It is the easiest thing to do. Maybe this is what the National Bureau of Investigation (NBI) did when they purchased the DNA analysis machine. It seems the scientific community and the industrial sector do not consult each other. Of course, DOST knows in principle that the linkage between these two sectors is very important. But there are certain modes that should be observed but are not being observed. For example, we do not have technology exchange or a technology market in the Philippines. This is very easy to set up. All we have to do is put out something like a separate section in classified ads. Maybe we can convince *Manila Bulletin*, the classified ads newspaper, to have a separate section on consultancy, technology-intensive products and services that can be bought and sold. So both buyers and sellers can advertise. This way, we shift some of the financial burden of diffusing R&D from government to the private sector.

In this country, most of the R & D expenditure is being underwritten by the government. Moving to a situation where both government and the private sector spend on R & D is what we would like to see happen. As it were, we have a situation where DOST has to compete for scarce government revenues. So apart from the problem of how to increase government revenues, the private sector must be convinced to spend money for technology. One way is to spend money locally in order to build capabilities instead of buying abroad and paying the royalties. This is the kind of linkage that should be fostered if we are to move from a purely and largely investment-led growth to what could be R & D-led growth.

There are many futurists who say that knowledge-based industries and services is the wave of the future. In this kind of situation R & D activities are very crucial. Creating new and useful knowledge that can be sold and bought in the market is vital, not

copying or adapting. We must produce new knowledge from within. This kind of innovation will come from the high-technology R & D labs as well as from the shopfloor level.

One other point that caught my attention is the observation that perhaps it is not macroeconomic modelling alone that will give us a better feel of what is happening. Dr. Patalinghug cited two things: technological convergence and the concept of social capability. I think the second is very important. There is so much that goes into R & D-driven productivity that is outside the realm of economics or even hard science. I think the question of how to develop "software" is very relevant. Many of the problems in this country are not hardware or hard science-oriented. They are human problems, social problems and I would like to see DOST address this. Spend more money on policy research, especially on the social side, on the assumption that the biggest problem in the country is on that side, not on the hardware side. And then come up with recommendations that can be used immediately by the policy-makers. Perhaps the best way to do this is to begin your research by asking clients what they need. This is what real linkaging is all about. Think tanks like UP-CIDS should identify topics by interviewing and asking the users directly what their needs are. So when the research is completed, there is a ready market.

10. Dealing with Intellectual Property Rights: The Philippine Case

Ramon L. Clarete

INTRODUCTION

A landmark outcome of the eight-year Uruguay Round multilateral trade negotiations under the General Agreement on Tariffs and Trade (GATT) is the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS). Along with several other agreements, the TRIPS was signed by in 1994 the respective ministers of the GATT members in Marrakesh, Morocco where the Uruguay Round of trade negotiations was officially concluded. The TRIPS accord is a major gain of developed countries which have sought, since the Tokyo Round, to define the standards and strengthen the enforcement mechanisms for the protection of intellectual property rights (IPR) in the world.[1]

As with the rest of the World Trade Organization (WTO) members, the Philippines faces the task of complying with the terms stipulated under the TRIPS accord. Unlike other multilateral IPR agreements, this WTO-sponsored accord carries trade sanctions for those members who choose to ignore it.

This paper reviews the factors leading to and the content of the TRIPS agreement, highlighting the various IPRs that it recognizes. This is followed by a discussion of the theoretical issues underpinning the advocacy for a strengthened IPR policy regime in the country. An attempt to define an agenda for Philippine compliance with the TRIPS is then made in the third section. A few remarks conclude this paper.

I. WHY GATT-UR NEGOTIATED TRIPS

Several factors had prompted developed countries (DCs) to put IPR issues at the forefront of international trade negotiations. One factor is the shifting of the comparative advantage of DCs from industrial products to technology and artistic products (Subramanian, 1991). The newly-industrialized countries have eroded the traditional share of DCs in the world's industrial markets. This has led DCs to identify intellectual properties as their emerging niche (see UNCTAD, 1995; Hartridge and Subramanian, 1991).

A second factor is the maturing of copying technologies which has greatly expanded the capacity to imitate. Investments made to develop new technologies are becoming more difficult to recover. The lack of adequate IPR protection across borders has nullified efforts on the part of DCs to realize their identified comparative advantage in intellectual properties (Cottier, 1991). Particularly vulnerable to imitation are industries such as pharmaceuticals, chemicals, and computer software.

A third factor is the apparent incapacity of the World Intellectual Property Organization (WIPO), a United Nations specialized agency to define and enforce standards for IPR protection and resolve IPR-related disputes among member countries. This is due to the nature of negotiations followed in WIPO which proceed on the basis of group coordination and voting. Moreover, the absence of any workable dispute settlement process prevents credible enforcement of IPR standards (Reinbothe and Howard, 1991).

The apparent failure of WIPO to enforce IPR standards worldwide has led DCs to impose unilateral initiatives for IPR protection. Most notably, the United States government passed its Trade and Tariff Act of 1984 that linked the extension of Generalized System of Preferences (GSP) privileges to the willingness of developing countries to provide "adequate and effective" IPR protection. Unilaterally provided, these GSP trade privileges are in the form of discriminatory tariff preferences granted to LDCs to increase their exports to DCs. In 1988, the Omnibus Trade and Competitiveness Act of the US government authorized the US Trade Representative (USTR) to list those countries that had been given deadlines to improve their

respective national IPR protection system and enforcement mechanisms. Under what is known as the Super 301, the US Trade Representative (USTR) is legally empowered by the US government to unilaterally withdraw concessions discriminately to force Super 301 countries to strengthen IPR protection in their respective territories. The European Union (EU) likewise moved in this direction as early as 1984, although it has not gone as far as to unilaterally and discriminately hit misbehaving LDCs (UNCTAD, 1995).

The threat to the multilateral trading system under GATT by such unilateral moves as the Super 301of the US, in turn, provided the pressure on both developed and developing countries to come to the negotiating table when they set the Uruguay Round (UR) agenda at Punta del Este, Uruguay in 1982. The DCs had pursued in the UR negotiations the adoption of a comprehensive agreement on all internationally important aspects of IPR protection. Some of these principles include national treatment, substantive standards of IPR protection, and rules on national enforcement.

While not closing the door to having IPR in the agenda, the developing countries nonetheless had initially narrowed the scope of the negotiating mandate of the UR on IPR protection to issues pertinent to counterfeiting and strictly trade-related issues. That in exchange for improvements in international IPR protection, the DCs should accord LDCs improved measures for the transfer of technology, was an essential part of the initial LDC agenda.

These varying expectations of the UR negotiators on IPR were only leveled during the Mid-term Review Conference in December 1988 in Montreal and in April 1989 in Geneva. A group of LDCs submitted detailed proposals pertinent to counterfeiting and piracy, as well as standards and principles governing IPR protection.[2] This development indicated a break in the Southern monolithic position which limited the scope of the UR negotiating mandate on TRIPS. While that group of LDCs had broadened LDC expectations regarding what the negotiations ought to produce, which is a comprehensive TRIPS agreement, the members nonetheless held on to their view that WIPO ought to implement the agreement. (See Reingbothe and Howard.)

The disintegration of the original LDC IPR agenda may be understood in light of the following (Cottier, 1991). The threat is real that DCs will unilaterally punish erring LDCs as far as IPR infringement is concerned. The US already has Super 301. While the EU has reservations about unilateral measures as these are inconsistent with the GATT's principle of nondiscrimination, it could follow the example of the US when it is convinced that the multilateral negotiations under the GATT could lead nowhere close to improving the present IPR protection system in the world.

On the positive side, the agenda of an improved enforcement mechanism which the DCs were promoting in the IPR agenda will benefit LDCs as well. The mechanism, once strengthened, can be used by them against the DCs in trade conflicts involving other trade. More importantly, the LDCs have increasingly understood that "adequate protection of IPRs is a beneficial factor in order to increase the flow of technology and know-how and to stimulate investment by facilitating licensing agreements." Lastly, the IPR negotiations is an opportunity to review and strengthen the checks and balances in the entire system to prevent excessive exploitation of enhanced protection by IPR holders.

II. AN OVERVIEW OF THE TRIPS AGREEMENT

The TRIPS agreement covers eight major areas. These are basic principles, substantive standards of IPRs, control of anti-competitive practices in contractual licenses, enforcement measures, settlement of dispute mechanisms, transitional arrangements, and "pipeline" IPR protection. In each of these areas, the agenda and outcome of negotiations are compared.

Basic Principles

The TRIPS Agreement aims to protect and enforce IPR in order to promote technological innovation and the transfer and dissemination of technology. In pursuit of this objective, it addresses the applicability of fundamental GATT principles to IPR protection,

defines measures to make enforcement of IPR more effective across borders, creates a credible mechanism for settling disputes pertinent to IPR enforcement, and provides transitional arrangements. It builds on existing international conventions on IPR such as the Paris Convention, Berne Convention, Rome Convention, and the Treaty on Intellectual Property in Respect of Integrated Circuits.

The principle of national treatment (NT), is a basic principle in the IPR conventions. This principle states that it is the legal obligation of any contracting party to extend the same treatment it extends to its own nationals to the nationals of other contracting parties with respect to IPR protection. There are exceptions to this as specified in existing IPR treaties. The principle is strengthened in the TRIPS agreement in so far as it applies to situations even outside of the provisions of the agreement itself for as long as these are relevant to IPR protection. This development is akin to the GATTification of the NT of the IPR treaties. In GATT, national treatment as well as the most-favored nation (MFN) principle, discussed below, are more like norms of behavior rather than simply legal obligations.

The MFN principle is introduced for the first time into IPR protection systems. And although the MFN principle has been enshrined in the GATT Law, its application to situations involving the upholding of IPR is unclear. There are existing multilateral or bilateral agreements which could be declared illegal if a totally unqualified MFN provision is applied. The EU did not believe the application of the MFN principle is necessary (Reinbothe and Howard). In the end, the MFN principle is introduced with categories of exemptions: situations not completely confined to IPR protection; existing MFN derogation grandfathered into the agreement; and derogation authorized by existing IPR treaties.

It is also important to note that contracting parties are provided flexibility in that they are allowed to set national policies necessary to protect public health and address other vital socioeconomic concerns provided that these do not conflict with the provisions in the TRIPS agreement. Moreover, measures may be adopted by members in their national IPR legal protection systems, again provided they are consistent with the TRIPS agreement, to curtail abuse of IPR rights holders.

One issue that the negotiations failed to resolve is the international exhaustion of rights. Article 5 of the agreement explicitly provides that the issue of exhaustion of rights be left unresolved, although an attempt was made to impose a system of international exhaustion of intellectual property rights. On this issue, developing countries are divided. Smaller ones believe that it is to their advantage to have an international exhaustion of rights in order to curtail the benefits of big Contracting Parties such as the US or EU from national exhaustion of rights. Others believe that international exhaustion of rights should be banned completely (Reinbothe and Howard, 1991).

Substantive Standards

At the start of the negotiations, DCs shared the view that the lack of IPR protection in the form of exclusions in certain areas (e.g., pharmaceuticals and chemical products) from patent protection, short durations of patent protection, and excessive compulsory licensing are inconsistent with the agreement's key objective of promoting technological innovation and the transfer of technologies and other intellectual creations worldwide. Accordingly they have fought for substantive standards in IPR protection.

This issue was controversial. Developing countries claim that their respective national IPR protection and enforcement systems address a complicated set of issues including but not limited to technological development. They also claimed that the DCs' proposal would undermine WIPO and is thus inconsistent with the negotiating mandate of the Uruguay Round. In reply, DCs invoked Articles 19 and 20 of the Paris and Berne Conventions, respectively, to argue that higher standards of IPR protection are allowed as long as they are consistent with existing provisions in IPR treaties.

Another issue raised was the proposal's inconsistency with GATT itself. Improved IPR standards may lead Contracting Parties to impose trade impediments or discriminate between other Contracting Parties. The bottomline is economic. DCs desire improved IPR protection in order to recover development costs and increase their earnings from technology exports. LDCs who import

technology resist stronger IPR protection as this will increase the cost of technology acquisition through payment of royalties and fees.

Substantive standards cover several categories of IPRs: patents, copyrights and related rights, trademarks, geographical indications, trade secrets and other undisclosed information, industrial designs and layout designs of integrated circuits.

Patents

In the area of patents, the following issues have been discussed: patentability, exclusions, non-discrimination, patent term, burden of proof, novel perceptions on obligations of patent applicants and owners, rights conferred, compulsory licenses, and the problem of government use. The following are some of the improvements made in the Uruguay Round.

First, patentability has become almost universal. Article 27:1 of the agreement covers all inventions, whether product or process, in all fields of technology without discrimination as to the place of invention, the field of technology and whether products are imported or locally produced. Excluded from this provision are situations involving public morality; situations related to protecting living things and the environment; inventions for diagnostic, therapeutic and surgical methods for the treatment of living things, plants and animals; and biological processes for the production of plants or animals. Exceptions to the patentability exclusions include microorganisms, biological processes for the production of microorganisms, and plant varieties which must be protected by patents and/or a *sui generis* system.

Second, patent life is set for a minimum period of 20 years from the time of filing.

Third, conditions have been set for the use of the rights to compulsory licensing. The TRIPS agreement continues to uphold compulsory licenses on all grounds but sets the conditions for the exercise of the right. Developing Countries (along with Canada) have argued that the invention should be "worked out" in the area where

the patent is given and that importation be excluded. Some of the conditions include the requirement that reasonable efforts be made to obtain authorization from the right holder on reasonable commercial terms (Article 31b) and termination of the license if the conditions for which it was granted no longer exist (Article 31g).

And fourth, process patent holders have been given more protection. Products identical to a product produced using a patented process are deemed to have been produced using the same process. The burden of proof therefore lies not on the patent process holder but on the producer of the identical product.

Copyright and Related Rights

The following are the highlights of the Agreement as far as copyright and related rights are concerned.

First, the essential provisions of the Berne Convention are upheld, though without any obligation to protect moral rights as stipulated in the Convention. However, Contracting Parties may do so without violating the provisions of the TRIPS agreement. Protection is accorded to literary or artistic expressions but not ideas, procedures, methods of operation, or mathematical concepts.

Second, neighboring rights are accorded to producers of sound recordings, performers, and broadcasting organizations. Performers are allowed to hold the right up to 50 years. This entitles them to prohibit unathorized reproduction and rebroadcasting of performances. Producers of sound recordings enjoy exclusive reproduction rights, while broadcasting organizations are granted exclusive rights to prohibit unauthorized fixation of broadcasts and reproduction and rebroadcasting by wireless means, as well as communication to the public of television broadcasting.

Third, computer software and databases are protected as literary works. In the negotiations, developing countries opted to retain flexibility by not requiring the standards for the protection of literary works of computer software and databases. Protection for

computer databases is made on the basis of selection or arrangement, rather than on the basis of the data or material itself. Thus, it is possible for another database on the same data to obtain a different copyright, provided that it has a differentiated arrangement as an existing protected database. In contrast, computer software is protected as a literary work without any qualification.

And fourth, the rights of Contracting Parties to permit both private use and use of protected materials for the purposes of teaching and scientific research with remuneration, as provided for under the Rome Convention, remain valid.

Trademarks

Trademarks are the least controversial in the TRIPS agreement. Some of the improvements in this category of IPRs are: (1) the term of protection per application is seven years and renewable; (2) there should be equal treatment of trade and service marks; (3) prior use is not a condition for granting trademark protection; (4) marks that are not yet used can be applied for protection and the application may not be refused in the first three years, on the ground of non-occurrence of intended use; (5) compulsory licensing is prohibited; and (6) restrictions on the use of trademarks are prohibited. The last one is a blow against India which had required foreign marks applied to goods produced under license to be used in conjunction with a local mark. The conditions for the registration of marks are likewise a compromise of the divergent views on prior use of the US and EU (Cottier, 1991).

Geographical Indications

Misrepresentation of a given product to suggest a false place of origin such that the public is led to believe that the product is of the same quality as products coming from a geographical area so noted for the high quality of its products, is declared to be unlawful under the TRIPS agreement. The EU and Switzerland fought for the inclusion of geographical indications in the agreement. The US, Australia, and Canada were against this provision.

Industrial Designs

The TRIPS agreement provides for the protection of industrial designs. However, contracting Parties are given flexibility in deciding whether a given design is "new and original" by recourse to a *sui generis* system. For example, proof that a given industrial design is substantially different from known designs or combinations of known designs may be requested before the design is accorded protection. In implementing this cumulative test for novelty and orginality, special consideration should be given to textile designs so as not to nullify short-lived market opportunities for fashionable goods. Also, designs largely dictated by technical or functional considerations are not eligible for protection. The protection for industrial designs lasts at least ten years.

Layout-Designs of Integrated Circuits

The multilateral initiative for the protection of topographies of integrated circuits is embodied in the treaty on Intellectual Property In Respect to Integrated Circuits (IPIC) concluded in Washington in 1989. However, Japan and the US rejected the treaty on the ground that it fell short of providing protection to layout-designs of integrated circuits. The TRIPS agreement embodies the consensus as to how these designs will be protected. The following are the improvements to this category of IPRs: extension of the term of protection from eight to 10 years from the first year of commercial exploitation or application for registration; extension of protection to articles containing the infringing layout-design; and provisions for the rights and obligations of the innocent infringer.

Trade Secrets

For the first time, a multilateral agreement protects undisclosed information or trade secrets. This is a new category of IPR intended to prevent unfair competition through disclosure of trade secrets. In the case of trade secrets with a commercial value, this IPR category provides incentives to right-holders to develop incremental

innovations not meeting the standard of patents. Trade secrets cover undisclosed test results or other data submitted to governments or governmental agencies in order to obtain marketing approval. This is particularly relevant to pharmaceuticals and agricultural chemical products. The TRIPS agreement provides workable definitions on what trade secrets are and obligations of Contracting Parties not to disclose such protected information unless it is in the interest of the general public welfare.

Control of Anti-Competitive Practices in Contractual Licenses

Strengthening the IPR protection system requires measures for ensuring a more effective transfer of patented and unpatented technologies to developing countries. Even before the TRIPS agreement, anti-competitive practices with respect to the grant of contractual licenses had been identified. These practices which retard the flow of technology from developed to developing countries include grant-back provisions; unreasonable requirements of exclusive dealings; restrictions on independent research and the use of personnel; price-fixing conditions; limitations on product adaptation; tying arrangements and burdensome exclusive distribution clauses; export restrictions and limitations on advertising; obligations to pay after the expiration of industrial property rights; and other burdensome clauses including unreasonable cross-licensing constraints and post-contractual limitations (UNCTAD, 1991).

While DCs have recognized the need to control abuses of IPRs, they nonetheless are not in agreement with developing countries over what constitutes restrictive practices. Industrialized countries have resisted the notion of presuming as unlawful per se these anti-competitive practices enshrined in licensing arrangements. While they were prepared to discuss measures to control these abuses of IPRs by rights-holders, DCs were unprepared to take the next bold step toward a multilateral initiative for competition policy. As national anti-trust laws are generally weak in developing countries, such a multilateral initiative would have been an important gain for developing countries (Cottier, 1991).

However, the TRIPS agreement does provide Contracting Parties the flexibility to regulate licensing practices which have adverse effects on competition in the relevant market. The text provides a limited list of illustrative anti-competitive practices in licensing arrangements such as grant-back conditions, coercive package licensing, and conditions preventing challenges to validity. A competition test is implicitly introduced by the agreement, whether or not a given practice in licensing arrangements constitutes an abuse of IPRs.

Enforcement and Dispute Settlement

Improved standards for IPR protection are as good as the enforcement and dispute settlement mechanisms that are in place. Thus, industrialized countries have pressed for stricter enforcement of IPR regulations by Contracting Parties. Indeed, the TRIPS provisions on enforcement are multilateral initiatives on matters of purely national concerns, e.g., provisions on due process, evidence, fair hearing and motivation of decision, appeal, delays, provisional measures and preliminary injunctions, *ex officio* action by border authorities, and damages and criminal sanctions related to trademark and copyright infringement. Besides internal enforcement commitments, there are also commitments to enforce IPR at the border. Contracting Parties are required to stop and destroy IPR-infringing articles. Enforcement measures at the border or inside the territory of a Contracting Party must be speedy and simple in order for IPR holders to prevent any act which infringe on their rights.

Dispute settlement procedures essentially follow those described in Articles XXII and XXIII of GATT 1994 as elaborated and applied by the Dispute Settlement Understanding. In case of noncompliance by a member country with the ruling of the Dispute Settlement Board, sanctions can be authorized by the WTO General Council.

Transitional Arrangements and Pipeline Protection

Developing countries and those in transition are given five years to comply with the provisions of the agreement. Least developed countries are given 11 years. In cases involving the extension of patent protection where none was applied before the WTO took effect, the concerned Contracting Party is given an additional five years. However, the enforcement of national treatment and most favored nation principles is due one year after the WTO took effect.

Where there is an extension of patent protection where none had been provided before, pipeline protection is given in the form of preservation of novelty during the ten-year transitional period and the granting of a period of five years of exclusive marketing rights provided conditions are met, e.g., a patent and marketing approval has been granted in one country and in respect to the other country, a patent application has been filed and a marketing approval has been granted.

III. ASSESSING THE IMPLICATIONS OF TRIPS

The main purpose of the TRIPS agreement is to protect and enforce IPR in order to promote technological innovation and the transfer and dissemination of technology. It is against this policy goal that an assessment of the possible implications of the agreement is made, although at this point it is too early to know the full ramifications of the accord.

A Framework for Evaluating National Net Benefits

One may start from the obvious that the adoption of improved technologies in a given country improves the welfare of the population of that country, all things being equal. Improved technology increases the productivity of the industries in the country which adopts state-of-the-art technology. Higher productivity in turn implies stronger economic growth and thus higher incomes per capita.

The adoption of any technology depends upon a lot of factors. Since technology is typically embodied in capital, these factors are also those which influence the investment decisions of business and household enterprises. The interaction of these factors in turn is reflected in the expected rate of return of capital invetments. If this is less than the opportunity cost of an alternative investment or than the cost of money, then the technology will not be adopted. However, one can argue that a given state-of-the-art technology can by itself improve the expected profitability of any capital investment in the business activity using the technology.

But this is an inadequate explanation of the investment decision process of investors. The size of the market of the industry to which the potential investor belongs and the nature of the capital investment that is to be made are contributing factors as well. If the investment creates a capacity far in excess of the market, the investment may not be made. This is especially true if the line of business that the investor is in is not internationally competitive due to trade protection. Trade protection limits the market of domestic industries and increases the likelihood that the investments will not be made on the ground of creating excess capacity.

Setting investment decision factors aside, access to technology is next in the entire decision process involving the adoption of technology. Access depends upon the cost of acquiring the technology. The payment of royalties, fees, and related dues increases the cost and thus lowers the incentive to acquire the technology. In an environment approximating competition, one can argue that these costs cannot possibly offset the benefit of acquiring the technology, assuming of course that the other investment constraining factors as mentioned above, are not binding. However, when anti-competitive practices are prevalent on the part of IPR holders, the cost of access to technology will limit the entire decision process to acquire and adopt an improved technology.

Free riding activities as manifested in counterfeiting and intellectual property piracy on the part of technology users are of course desirable from their viewpoint. The cost of technology acquisition is near zero. This happens when property rights to intellectual creations are ill-defined. In such a situation, these

intellectual properties are public domain and thus freely accessible. But when the system is defined and the enforcement thereof is imperfect, there is a cost to free riders. The decision of domestic firms to violate IPRs depends upon the penalties that they have to shoulder if caught, the benefits of acquiring the technology without paying for its cost, and the probability that they will be caught. In a weak legal system of IPR protection, the probability of being caught is low, which raises the attractiveness of violating IPRs. Conversely, a strong legal system will undoubtedly lower the incentive to free ride. The analysis here applies to tax evasion, for example.

On the supply side of technology development, research and development (R & D) firms will not invest in technology development if they are unable to recover their investments and earn at least the normal return to such investments. In an environment with a very weak IPR legal protection system, the prospect of recovering and earning from R & D investments is poor. The incentive for technological innovation therefore is low. Conversely, a strong IPR protection system increases the likelihood of R & D investments.

Case of Weak IPR Protection System

When the legal system is imperfect with respect to protecting IPRs, the exporting and importing countries interact in a game-theoretic situation. The technology exporters, i.e., the rich countries, have a monopoly over the technology and the products created with it. The technology importers, i.e., the developing countries, have the monopoly of designing and enforcing a national legal system for the protection of intellectual properties. This game-theoretic situation occurs in the territory of the technology importer.

The outcome of this game between the buyer and supplier of technology depends upon the strategies each player employs. Vishwasrao (1994) has examined the situation when the foreign firm supplying the technology has the choices of licensing a new product to a firm in the importing country, licensing it to a subsidiary, or exporting the technology. Subsidiary production avoids the risk of

imitation but involves higher costs for the the supplying firm. Significantly, the gains of the technology importing country from the lack of IPR protection may be more than offset if the firm in the technology supplying country transfers the technology via subsidiary or monopoly production. Moreover, the licensing contracts for the use of the technology take the form of up-front lump sum fees rather than royalties.

This analysis discounts the obvious adverse impact of a unilateral withdrawal of trade concessions by the technology supplying country in retaliation for the technology importing country's failure to strengthen a weak legal protection system for IPRs. If this is part of the strategy of the former, a trade war can occur. This puts the technology importing country at a disadvantage, particularly if it it is smaller and weaker than the supplying country and the former has substantial commercial exports to the latter.

On the other hand, the benefit of IPR infringement for the technology importing country tends to go down the slower the country is able to copy the intellectual property. Thus, countries with policy regimes conducive to private investments, as in the case of the newly-industrializing countries, are likely to benefit from IPR infringement more than the rest of the developing countries. Therefore, it may not pay off to violate IPR infringement if it takes the technology importing country years before an innovation differentiated enough from the protected technology is made. To the extent that technology imitations require investments in capital, the climate for investments in the technology importing country may be critical in appropriating the benefit of IPR infringement.

Strengthening IPR Protection

All things being equal, an improved IPR protection system closes the "protection gap" between technology supplying and buying countries. This in turn tends to induce innovating firms in the supplying countries to transfer new technologies. Empirical evidence of this increased willingness of transnational corporations to invest in a given country with stronger IPR protection is available (Mansfield,

1994). The increased transfer of technology in turn may lead to more disclosures of inventions, which would ultimately result in further innovations occurring in the technology importing country.

But the the linkage between an improved IPR protection system and increased transfer of technology is not at all clear. While Mansfield's survey tends to support this view, several factors provide an alternative outcome. First, on the part of suppliers, the licensing of technology will not be as forthcoming if the factors pertinent to investment decisions indicate a limited market in the immediate time horizon. That is, the decision to license the technology in the importing country is akin to one involving investments to produce the product or service to be sold to the importing country. Second, on the part of technology users, there may be a mismatch between technologies available for licensing and their needs. An industrializing country with high prospects of more and diversified industrial exports is more likely to find state-of-the-art technologies useful. A third factor is the nature of complementrary FDI policies in the technology using country. If these are restrictive, then the prospect of technology transfers, even under a stronger IPR protection system, may slow down the process. There is preference for transferring technologies via subsidiary production rather than licensing.

These other factors affecting the process of technology transfer notwithstanding, the international effort to strengthen IPR protection broadens the choices of firms in the innovating and using countries for reducing the uncertainties involved in the development and transfer of technology and other useful artistic creations. The TRIPS agreement realizes an essential condition for any contractual exchange to occur: a legal protection system of the rights of the parties to a contract. A clear assignment of legal rights and obligations to the contractual parties, effective enforcement thereof, as well as a credible mechanism for resolving disputes arising from the enforcement of the agreement, constitute the essential contributions of the TRIPS agreement to the strengthening and broadening of the IPR protection system.

Balancing these broadened and improved IPR protection for owners is the equally important definition of the rights of users of intellectual property to defend themselves against abuses. The provisions in the agreement dealing with the control of anti-competitive provisions in licensing arrangements represent the careful effort of negotiators to come up with a mutually beneficial outcome. Although the TRIPS agreement represents a victory for the developed countries, benefits to technology-deficient developing countries may more than offset their increased obligations under an improved IPR protection system. This is particularly true if developing countries look carefully at the flexibilities provided them in the agreement, particularly those dealing with the control of abuses of IPR holders.

IV. PHILIPPINE COMPLIANCE WITH THE TRIPS AGREEMENT

Legislative Agenda

Compliance with the TRIPS agreement entails both a legislative agenda and improved enforcement mechanisms. Philippine laws dealing with IPR protection are contained in Republic Act (RA) No. 166 or the Trademark Law, RA 165 or the Patents Law, and Presidential Decree (PD) No. 285 or the Reprinting Law. In an earlier pronouncement during the period for ratifying the Uruguay Round Final Act, the government indicated the need to amend the Trademark Law to include the provision that trademarks can be filed and granted even if the product is not being used.

With respect to the Patents Law, the patent holder must be provided the added right to import the product, if this is produced in another country. The term of protection is extended to 20 years from the time of filing. The present law provides a 17-year term of protection from the time of award of the patent. Thus, this particular provision neither extends nor shortens the actual term of protection since it takes about two to three years from filing before patents are granted.

On the other hand, the implication of the TRIPS agreement on the Generic Law needs to be studied. One view during the ratification of the GATT treaty claimed that the Generic Law would be inconsistent with the agreement in about five percent of the pharmaceuticals covered by the law. Another view argues that this is not so.

The most controversial part of the amendment has to do with the extension of protection to plant varieties either through patents, a *sui generis* protection system, or a combination thereof. The present Patent Law covers only industrial products and excludes life forms. The current effort here is tied to efforts to conserve the country's genetic biodiversity. On one level, the tensions are linked to basic differences in the perceptions of the extent of value added by innovating firms to the the indigenous plant varieties and microorganisms in the country in the process of technology development. Such tensions are stronger when the innovating firms are transnational companies, which in turn casts the compliance process into the classic transnational DC-LDC exploitation paradigm in which the developing country is forced to become a source of raw materials and the market for the finished products thereof by transnational corporations. The debates also extended to the assignment of IPR to indigenous communities with respect to the contribution of a plant variety or microorganism found to be indigenous to the territory of a given community to the overall value of the technology developed. The discussion has not spilled into the messier administrative details regarding the level and manner of payment of royalties and fees which are applicable.

Meanwhile, environmentalists are concerned that tinkering with living things in the pursuit of biotechnology development will open up unexpected and unknown problems which may have adverse impacts on the ecosystem. Another level of the debate focuses on the concern that IPR protection has gone too far into the sacred area of life itself. The idea of providing patent protection to plant varieties and microorganisms puts the legal system in the neighborhood of violating the moral principle governing the nonmarketability of human life. This is particularly true when in the process of technology development the use of parts of the human body is required.

At a third level, there is the clash between farmers' privilege and breeders' rights with respect to the extension of IPR protection to plant varieties. This would have been very valid if the TRIPS agreement required mandatory patentability of plant varieties. Even if this were so, it would very likely be an unimplementable provision precisely because of the smallholder nature of the agriculture sectors in many developing countries. It would have been as administratively difficult as collecting the ideal land tax. Perhaps in recognition of this administrative difficulty and mindful of the debate on the appropriate reconciliation of the conflicting interests between users and breeders, the TRIPS agreement has provided the legal flexibility for a weaker *sui generis* IPR protection system.

No one actually knows how to define a *sui generis* IPR protection system. Whatever works and is consistent with the key provisions of the TRIPS agreement must be a *sui generis* system. In an effort to help the Indian Government resolve the farmers' protest regarding the inclusion of plant varieties in the scope of patentable subject matter, former GATT Director-General Mr. Peter Sutherland said that the UPOV 1978 may be an example of a *sui generis* protection system. This opinion has not been challenged in the WTO.

Still another concern is that however one strikes an appropriate balance between farmers' privilege and breeders' rights, the cost of seeds may rise in recognition of the improved IPR protection for plant varieties. This concern, which is valid, should be balanced with the possibility that prices of seeds will go down due to increased competition in the production of commercial seed varieties. If IPR protection is improved, technology development and commercialization by domestic breeders will be encouraged. This in turn provides more options for farmers. The competition of differentiated seed varities may bring down the prices of seeds. While in the short run there may be monopoly profits for existing breeders, such profits will be reduced to a minimum if the government assures adequate protection for the rights of any firm to enter and exit the seed industry.

The resolution of these tensions regarding the provision of IPR protection for plant varieties would constitute the most challenging task of the Philippine government in the next five years. At present, there are bills in the Senate which reflect the key concerns of the

environmentalist groups. These bills need to be studied closely if we are to avoid the mistake of again passing measures against unfair competition which are clearly protective of the interests of domestic industries but are useless because they are inconsistent with the GATT law.

As for the Reprinting Law, the government must extend rental rights applicable to computer programs, cinematographic works and sound recordings to 50 years (currently 20 years). The government must also look into the inclusion of geographical indications, trade secrets and integrated circuits; and the ratification of the Berne Convention on Copyrights. The current Director of the Bureau of Trademarks and Patents has also suggested that the Philippines submit a reservation with respect to the Rome Convention.

Enforcement Mechanisms

The adequacy of existing Philippine enforcement mechanisms to meet the standards required by the TRIPS agreement should be examined. According to the United Nations Conference on Trade and Development (UNCTAD), this is not a trivial matter for many developing countries, particularly if a developing country has to start from zero enforcement capacity as in the case of Bangladesh.

In the Philippines, copyright matters are handled by the Department of Education and Culture. Trademarks and patents are regulated by the Department of Trade and Industry (DTI). The new IPR categories involving geographical indications, trade secrets, and topographies of integrated circuits will most likely be managed by the DTI. However, plant variety protection is assigned to the Department of Agriculture. The matter of protection of pharmaceuticals is within the authority of the Department of Health. An inter-agency body consisting of representatives of these departments may be formed to discuss issues pertinent to the enforcement of IPR regulations.

Concluding Remarks

The matter of IPR protection is here to stay and the sooner policy makers and other policy circles accept this, the better for the country. Wishing for the return of the old days of a weak IPR protection system that would allow the country to take a "technological leap" forward through IPR piracy and infringement is counter-productive. A more constructive alternative is to acquire a good handle on the legal flexibilities within the agreement and use these to our advantage.

NOTES

[1] At the end of the 1978 Tokyo Round I, the negotiators completed the draft agreement on counterfeiting. However, they failed to vote to include the agreement in the results of the Round. Only the United States (US) and European Community (EC) governments supported the agreement. See Hartridge and Subramanian (1989).

[2] These countries are: Argentina, Brazil, Chile, China, Colombia, Cuba, Egypt, India, Nigeria, Peru, Tanzania and Uruguay (see UNCTAD, 1995).

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COMMENTS

*Rogelio A. Vinluan**

Dr. Ramon L. Clarete has a very illuminating paper on the salient features of the TRIPS Agreement and its implications on the promotion of technological innovation and transfer of technology.

Dr. Clarete pointed out that the main purpose of the TRIPS Agreement is to protect and enforce intellectual property rights (IPR) in order to promote technological innovation and the transfer and dissemination of technology. He noted that "the linkage between an improved IPR protection system and increased transfer of technology is not at all clear." He is not alone in this observation. A Yale economist, Robert Evanson, has raised the same question of whether the willingness of foreign technology suppliers to provide technology to developing countries is improved by stronger IPRs. According to Prof. Evanson, the literature on the subject does not show a strong correlation between direct foreign investment and the strength of the IPR regime. Another economist, Prof. David Morrey of Berkeley, has expressed the view that the TRIPS agreement will have a fairly modest effect on direct foreign investment. The forces driving growth in direct foreign investment are much broader and certainly subject to a much wider array of influences than those flowing from the international IPR regime.

Let me go to the second part of Dr. Clarete's paper on Philippine compliance with the TRIPS agreement. Dr. Clarete indicated that compliance with the trade agreement will entail a legislative agenda and improved enforcement mechanisms. The Philippine government's actual legislative agenda include the following pending bills.

First, Senate Bill No. 921 and House Bill No. 5648 entitled "An Act Revising the Philippine Patent Act of 1995." This bill proposes that before a compulsory license is granted it must be shown that the petitioner has made an offer to the patentee to license the patent under reasonable terms but the offer was rejected. This bill also proposes that if the patentee has brought into the country an invention for commercial exploitation, a reasonable royalty based on the economic value shall be considered. This would meet the need of the consumers for affordable products without depriving the patentee of any economic advantage he would normally gain from his patent.

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Second, Senate Bill No. 963 and House Bill No. 5649 entitled "An Act to Provide for the Protection of Trademarks, Tradenames and Service Marks." These bills mandate that prior use of the trademark in commerce in the Philippines is no longer a requirement for filing a trademark application.

And third, Senate Bill (SB) No. 964 entitled "An Act Providing for a New Copyright Law of the Philippines" for the protection of literary, artistic and scientific works. SB 964 introduces the following amendments to Presidential Decree (PD) No. 49 as amended by PD 1988: (a) the repeal of PD 285 as amended by PD 1203 known as the Printing Law which allows the compulsory licensing of textbooks, and to substitute in its place a system that authorizes the compulsory licensing of the right to reproduce or translate textbooks in accordance with the Berne Convention as revised in Paris in 1971; (b) the protection of compilations of data or other materials which are construed as intellectual creations; and (c) granting the authors and producers of computer programs authority to allow or prohibit their commercial rental.

The measures to improve enforcement mechanisms may be classified into legislative, executive and judicial measures. In the legislative arena, the proposed bills will increase the penalties for infringement. Executive Order No. 60 was issued by the President of the Philippines in February 1993 to establish the Presidential Inter-agency Committee on Intellectual Property Rights. Its main objective is to coordinate the activities of government agencies dealing with the administration and enforcement of intellectual and industrial property rights, and the policy-making process of the executive branch on matters relating to intellectual property. This agency has been in existence for two years and the record shows that in 1994 the number of establishments apprehended for IPR violations rose to 4,100 from an annual average of 320 establishments from 1991 to 1993. In the judicial arena, the Supreme Court issued Administrative Order No. 11395 in October 1995 designating 27 regional trial courts and 27 municipal trial courts as special courts for intellectual property rights. The order mandates that these courts shall take cognizance of all cases of violations of intellectual property. In this circular the courts

are directed as follows: "Trial shall be immediately commenced and shall continue from day to day to be terminated as far as practicable within 60 days from initial trial. Judgement shall be rendered within 30 days from the date of submission for decisions."

I certainly agree with Dr. Clarete that our policy-makers should be resigned to the fact that IPR protection is here to stay. I think the time for debate is over. The wave of the future is toward a unified global intellectual property rights regime. For the Philippines the order of the day is to use our intellectual property law system to promote domestic innovation and to improve our ability to buy technology on better terms.

COMMENTS

*Llewellyn L. Llanillo**

As an intellectual property rights lawyer, I am of course biased in favor of intellectual property protection and I cannot agree more with Dr. Ramon Clarete's conclusion that there is really nothing more that we can do at this point but to implement our IPR laws. The sooner policy-makers, producers and consumers accept this fact the better for all of us and for the country as a whole.

In fact, the issue of intellectual property protection is not really new. IPR protection is enshrined not only in the present Constitution but even in the first Constitution of 1935. We have signed conventions regarding intellectual property law. Let me cite a few of these. We have the Trademark Law, the Patent Law, and the Copyright Law or what is otherwise called the Intellectual Property Decree. We have signed the Paris Convention for the protection of industrial property and we have been abiding by it since 1965. We have been a party to the Berne Convention for the protection of literary and artistic works since 1951 and to the Rome Convention for the protection of performers, producers of phonograms and broadcasting organizations since 1984. We of course are a member of the World Intellectual Property Organization. With respect to the patenting of microorganisms which is apparently a controversial issue, we have been a party to the Budapest Treaty since 1981. So government policy over the years has really been for the protection of intellectual property rights.

At the risk of being redundant, let me recite the reasons for a strong IPR protection system. Dr. Clarete argued that a strong intellectual property rights system encourages economic growth, increased domestic research and development, and possibly also more foreign investments. There is a divergence of opinion here. My own personal view is that it does not really increase foreign investments. What it does is remove a disincentive to investments in the country.

What really matters for foreign investors is that they make money. Regardless of whether there is IPR protection or not, they will come in. The problem with our country is that we do not have the appropriate physical infrastructure to attract foreign investments.

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We do not have a steel industry to speak of. What we have is a plant that simply flattens steel imported from Brazil. We do not have a plant to convert ore into iron or to steel. We do not have a petrochemical industry. We also do not have a plastics industry. We import our materials and so we cannot really copy the high technology products that we are talking about. What counterfeiting and piracy there is, is really piracy of very low technology products. Most of these violations concern trademarks of popular brands. Thus, we are at the very bottom of the totem pole even when it comes to copying foreign technology.

So I think that instead of concentrating on IPR, perhaps we should focus on something else. We should not waste our time discussing the IPR issue. For example, from a study conducted late last year we found out that there is very little use of the Bureau of Patents facilities for patent searches, and that is supposed to be a source of technology information. In 1994, only 804 patent searches were conducted by the public of which only 61 were made by businessmen or entrepreneurs. In 1983 the total number of patent searches conducted by the public was only 575. Of this only 42 were made by businessmen. Of this very small number of searches, many were done by government institutions like PCARRD [Philippine Council for Agriculture, Forestry, Natural Resources Research and Development], and the University of the Philippines in Diliman and Los Baños. This very meager use of patent searches is mirrored by the paucity of issued patents. The figures show that local patent holders own less than 10 percent of total patents granted. More than 90 percent is foreign-owned. In 1994 there were 181 local patents while the foreign-owned patents numbered 1,965. In 1993 local patents numbered 178 and foreign-owned patents numbered 1,860. In 1992 there were 133 local patents and 1,687 foreign-owned patents. This has been a consistent trend.

The non-use of the patent component of the IPR system may be attributed to the following. First, technologies are obtained from other sources such as foreign licensees who are also investors and equipment suppliers. Second, IPR is not a priority among our businessmen, their basic priority needs being money, equipment, raw materials, etc. Third, there is very little indigenous technology

that qualifies for patenting. Lastly, there is really a very low level of IPR awareness among the public. They do not know that they can take advantage of the IPR system. So I think that the thrust should be a continuing program of IPR education and information dissemination that will make the public understand that there is an IPR infrastructure that they can take advantage of. I think that we should simply stop debating about whether having an IPR system is good or bad.

11. Trade and Environment Linkages

Ponciano S. Intal, Jr.

INTRODUCTION

The rise of the environment as a major economic issue in the late 1980s and in the 1990s has inevitably spilled into the international trade arena, in part because the period coincided with the Uruguay Round negotiations meant to redefine the international trading system. Although there was no special negotiations group on trade and environment formed during the Uruguay Round, the rise of environmentalism in the world, especially in the developed world, and the worldwide adoption in recent years of the call for sustainable development (which became most politically salient at the United Nations Conference on Environment and Development in Rio) have influenced to some extent the outcome of the Uruguay Round negotiations. Thus, for example, the Preamble to the agreement establishing the World Trade Organization (WTO) explicitly states for the first time the objective of sustainable development.

The meeting of the Trade Negotiations Committee (which oversaw all activities related to the Uruguay Round), held to adopt the Final Act of the Uruguay Round negotiations, also adopted a Ministerial Decision on Trade and Environment which committed the WTO to draw up a work programme in this area, taking the perspective that there need not be policy contradiction between an open, nondiscriminatory and equitable multilateral trading system and the protection of the environment (GATT, n.d, p.8). The Ministerial Decision directed the first meeting of the WTO General Council to establish a WTO Committee on Trade and Environment. Thus it is likely that succeeding rounds of multilateral negotiations will include high level discussions, if not negotiations, on how to reconcile the concerns of environmental protection with open and nondiscriminatory multilateral trading arrangements.

The high priority given to the establishment of the WTO Committee on Trade and Environment highlights the increasing environmental subtext to international trading. First, the potential for conflict between environmental concerns and international trading is increasing in view of the mushrooming of international environmental agreements (over 150 by 1990), many of which have trade provisions (U.S. Congress Office of Technology Assessment, 1992, p.3). Second, the increasingly tough environmental regulations in the developed countries are endogenously determined, supported by increasingly "green" consumer expectations in the developed world and the view that improving the environmental performance of processes and products is a new competitive edge for businesses and countries (Schaper, 1992). The ongoing process of development of the International Organization for Standardization's (ISO) 14000 environmental standards is reflective of the shift toward integrating environmental considerations in business decisions.

As it moves toward increased export orientation, it is essential that the Philippines recognize the new international trade and environmental paradigm. Thus, for example, the adoption and institutionalization of ISO 14000 can be expected to significantly affect the prospects and costs of exporting for many of the country's industries. Export-oriented industries are vulnerable to "green consumerism" in the major export markets as exemplified by what the tuna-dolphin issue in the United States did for Thailand's tuna industry. The country's performance on the environment may even become a factor in its export success. For example, there has been a persistent call in the developed countries for the use of a certification requirement that wood product exports or furniture exports come from sustainably managed forests.

There are also compelling domestic reasons for bringing the trade and environment nexus into closer scrutiny and higher policy profile in the Philippines. Resource depletion and environmental degradation constitute the country's record with respect to the environment. This is matched by a historically poor economic record. Just as the series of policy and structural reforms on the economic front during the past decade are meant to put the economy on a sounder footing, the adoption of the Philippine Strategy for Sustainable Development in 1989 and the subsequent initiatives

are meant to redress environmental degradation and address key structural problems that significantly contributed to environmental degradation. Arguably, however, the government has been more assiduous in implementing structural economic reforms than structural and institutional reforms for improved environmental management and protection.

This paper explores the issue of trade and environment linkages and looks into the challenges facing the country in the light of the increased importance of the environment factor in the international trading system. Section I of this paper presents some analytic concepts on the impact of international trade on the environment and the choice of policy instruments to address the problem of environmental externalities. Section II discusses the GATT/WTO and the environment, and the "greening of international trade." Section III presents simulation results on the impact of trade policies on the Philippine environment and looks into the issue of the possible impact of environment protection policies on the international competitiveness of Philippine industries. And Section IV presents some policy and institutional implications of the emerging new trade and environment paradigm.

I. SOME ANALYTICAL CONCEPTS

Effects of international trade on the environment[1]

International trade can have both positive and negative effects on the country's environment. The effects are classified into three categories (OECD, 1994): (a) **product effects**, through the flow of particular goods and services which have environmental impacts; (b) **scale effects**, related to the expansion of level of trade, production and consumption; and (c) **structural effects**, related to the intensity of production and consumption activities. For all three categories, there are both positive and negative effects on the environment. Moreover, these effects on the environment consist of both direct and indirect effects. Hence, *a priori* it is not possible to determine whether international trade impacts positively or negatively on the environment.

The most important examples of products and services with positive environmental effects are environmental technologies and services used to address specific environmental problems. International trade allows the worldwide spread of such technologies and services. Another important positive contribution of international trade to domestic environmental protection and management is that trade allows the importation of products which are resource extractive (if produced domestically, these would significantly worsen the country's resource stock, like logs and lumber) or which, if produced domestically, would be too pollutive (without appropriate pollution control measures) or expensive (if appropriate pollution control measures are instituted).

Examples of products with potentially negative environmental effects include hazardous or toxic wastes and dangerous chemicals. For these classes of commodities, an element of trade control is necessary for proper transport and disposition, such as the Vienna Convention on Hazardous Wastes.

The scale effects of international trade on the environment arise from the impact of international trade on the expansion of the scale of economic activity either in a given sector or in the overall economy. The positive scale effects relate to the positive contribution of international trade to the rise in national income, and therefore the increased capacity of the country to provide funding for environmental protection. The negative scale effects arise from the country's failure to address the problem of negative externalities of production; in effect, poor environmental management.

The structural effects of international trade on the environment, which are more indirect than the product or scale effects, come from the changes in the location and structure of production and consumption arising from the opening up of the economy to greater foreign trade competition. Given that each industry has a different pollution intensity, then the configuration of production and consumption arising from a particular foreign trade policy regime implies a particular overall pollution intensity.

It must be pointed out that the negative effects on the environment arising from both the scale effects and the structural effects stem fundamentally from failures to adequately incorporate the externality costs to the environment and from inappropriate pricing of natural resources and services.

In general, international trade is not the root cause of environmental problems which are due primarily to "market failures" and "intervention failures." Market failures arise when markets do not reflect environmental values or the externality costs of production and consumption. As a result, there is a divergence between the outcomes from the perspective of the concerned private participants in the market and the outcomes from the perspective of the whole society. Market prices fail to reflect the costs to the environment because it is often difficult for firms to recognize, measure and collect such externalities. In addition, market prices may reflect the undervaluation of resources and the social benefits from the ecosystem. Finally, market failures arise from ill-defined property rights which may lead to overexploitation or overconsumption of an environmental asset (e.g., natural resource, air, water).

"Intervention failures" occur when the government fails to correct for market failures and creates or exacerbates market failures. In the end, the presence and severity of environment problems relate to government environment policy intervention failures or to the lack of appropriate environment policies. This may occur because of poor knowledge regarding the interaction of the environment and the economy, the political economy of environmental decisions, or inadequate understanding of the appropriate policy choices in the presence of environmental externalities. Only continuous research will enable a better understanding of the dynamics between the environment and the economy.

Welfare analysis of trade and environment policies in a small, open economy

Given environmental externalities in production and consumption, would the imposition of trade measures improve environmental conditions? If so, at what cost? The standard welfare analysis of trade and environment policies in a small, open economy

(Anderson, 1992) provides some framework for looking into the choice of appropriate policy instruments. Specifically, if the negative externality is in the production process (e.g., pollution from manufacturing), a reduction in tariffs and nontariff barriers will lead to increased (lower) environmental stress if the production industry is exportable (importable). Whether or not the overall impact of the trade liberalization on the environment is positive depends in part on whether the societal benefits from more efficient allocation of resources outweigh the costs to the society of the degradation of the environment. If, on the other hand, the negative externality is on the consumption side (e.g., emissions from diesel trucks), reducing import tariffs and nontariff barriers (e.g., importation of trucks) would contribute to the deterioration of the environment in the country.

An important insight from the theory of optimal interventions in the economic literature is that where there is an externality or a distortion in the economy, the most efficient approach is for the government to intervene directly at the source. This prescription minimizes the unwanted and distortionary side effects of the government intervention. For example, where there is a production externality, the ideal solution is to address this directly at the source by means, for example, of the imposition of a pollution tax. If a trade measure is used instead, not only is the level of production affected but also the level of consumption. In fact, where the response is the imposition of higher tariff, the environmental situation would even worsen because domestic production (which is pollutive by assumption) increases.

This discussion suggests that if there is appropriate government intervention at the production or consumption end to address the problem of a production or consumption externality, then trade liberalization (which is brought about by a reduction in tariffs and nontariff barriers) could contribute to an overall improvement in the welfare of the economy through improved allocation of resources and the concomitant increase in national income. Thus, for example, where the industry is an importable and is highly pollutive in its production process, trade liberalization which increases the country's reliance on imports will improve the country's environment and even its welfare. Moreover, if there is a production tax imposed on the

domestic production of the importable good (in order to incorporate the social cost of pollution arising from the domestic production of the importable and hence encourage the adoption of pollution control measures in the concerned industry and prevent unnecessary implicit subsidy on the domestic production of the importable), then the country's overall welfare would improve further.

The emerging international trade policy regime is increasingly moving toward free trade. The long term goal of the WTO is to institute an international system that is as close to free trade as possible. The vision of the ASEAN Free Trade Area (AFTA) is to have at most five percent tariff within the ASEAN region for manufactures and non-sensitive agricultural products. Similarly, the Bogor Declaration envisions free trade reigning in the Asia Pacific Economic Cooperation (APEC) region by the year 2020.

This discussion suggests that the drive for freer trade would have to be complemented with improved domestic environment management such that domestic market prices will reflect the social costs of pollution or environmental damages from domestic production and consumption. In addition, this framework indicates that the best way of strengthening domestic environmental protection is *not* the imposition of international trade sanctions or barriers (e.g., tariffs, anti-dumping) but through direct policy interventions addressing the root causes of the environmental problems. Thus, there need not be any policy contradiction between the drive for open, multilateral trading and the protection of the (domestic) environments of the member countries.

The discussion so far deals with purely domestic environmental concerns that require domestic policy interventions. However, the international debate on the trade and environment nexus has also been concerned, if not more so, with "global commons" like the ozone layer. It is argued that in the case of global commons, the use of trade policies (e.g., sanctions) may be defensible. Nevertheless, the analytic framework discussed above suggests that even for the case of "global commons," the use of trade measures is still a second-best option compared to an international agreement that encourages all concerned countries and governments to address the problem through

an internationally coordinated program of domestic interventions using production-related or consumption-related domestic measures like environmental taxes, more appropriate user charges in the use of natural resources, and the like. The role of international trade measures (e.g., sanctions, tariffs) is primarily to prevent or minimize shirking or free riding among governments. They are not the primary means of addressing the problem of global commons.

II. GATT/WTO, THE ENVIRONMENT AND THE "GREENING OF INTERNATIONAL TRADE"

GATT/WTO and the Environment

The General Agreement on Tariffs and Trade (GATT) provides the basic legal context of the interaction between international trade and the environment. The dominant view is that the provisions in the GATT as updated by the results of the Uruguay Round allow countries to institute appropriate domestic environmental policy measures to address their respective domestic environmental problems and concerns. Such measures, however, should not create unnecessary obstacles to trade.

The GATT report on Trade and the Environment states that:

> *GATT rules...place essentially no constraint on a country's right to protect its own environment against damage from either domestic production or the consumption of domestically produced or imported products. Generally speaking, a country can do anything to imports that it does to domestically produced products, and it can do anything it considers necessary to its own production processes.* (GATT, n.d.)

GATT imposes limitations on the member country's choice of specific measures for the protection of the domestic environment, in order that such measures are not used as a means to protect domestic industries from import competition. Thus, for example, the GATT Agreement on Technical Barriers to Trade states that the regulations

are no more trade restrictive than necessary to fulfill a legitimate objective, taking into consideration the risks that non-fulfillment of the objective may entail.

So far, domestic environmental regulations in GATT member countries are largely governed by GATT principles, especially of nondiscrimination and national treatment. GATT panels on the environment-related cases that have been brought to them, as perhaps best exemplified by the tuna-dolphin issue lodged by Mexico against the United States, have blocked attempts to institutionalize environment-related trade restrictions. To the extent that governments recognize the need for a rule-based liberal international trading system, GATT members are unlikely to break GATT/WTO's rules (Intal and Quintos, 1995).

There is greater disagreement over the effectiveness of the current GATT/WTO in dealing with transborder or "global commons." Many environmentalists feel that GATT/WTO rules sometimes pose obstacles to the adequate protection of the environment. To a large extent, the GATT/WTO is not the main venue for international negotiations on the environment. International environment agreements (IEAs) have surged in number since the latter 1980s. Many of the IEAs have trade provisions that tend to be discriminatory against non-signatories. But there is concern that the IEAs may not be completely compatible with GATT/WTO rules. Thus, the relationship between the trade provisions of the international environment agreements and the GATT/WTO provisions need to be clarified and reconciled, either *a priori* (similar to trade measures in the framework of international commodity agreements, in terms of the interpretation of GATT Article 20) or *a posteriori* (by obtaining GATT waivers).

How the international environmental agreements (addressing global commons) are accommodated in the international trading system is one of the more contentious issues being discussed in the WTO Committee on Trade and the Environment (CTE). Specifically, developing countries are against the proposal to accommodate the IEAs *a priori* through an interpretation of Article XX GATT (as proposed by the European Union) because they fear that the

amendment would become the avenue for the use of the environmental issue for protectionist purposes. On the other hand, developed countries tend to be against the *a posteriori* approach through the granting of a WTO waiver because a WTO waiver is granted only in "exceptional circumstances," requiring a three-fourths majority vote and an annual review for waivers lasting longer than one year.

There are proposals from a number of WTO members aimed at breaking the impasse. These proposals tend to simplify the process for the granting of a WTO waiver for environmental agreements or set criteria for the use of trade measures in international environmental agreements. However, the emerging consensus remains unclear although there is some pressure on the CTE to arrive at a consensus in the run up to the first WTO Ministerial Meeting in Singapore in December.

To sum up, the GATT/WTO rules as they bear on domestic environmental concerns of WTO member countries are consistent with the analytic framework discussed above on the relationship between trade and environment policies in a small, open economy. The GATT/WTO limitations are meant essentially to prevent the use of domestic environment measures as a means of protecting domestic industries from import competition. With respect to transborder and global environmental concerns, the key means of international cooperation is the propagation of international environmental agreements, rather than the GATT/WTO. Many of these environmental agreements have trade provisions which have yet to be clarified and/or reconciled with the current GATT/WTO rules.

Subsidiarity, standards and "green protectionism"

The principle of subsidiarity applies to international environment policy. Where the environmental problem is local or national in scope, it is best dealt with at the local or national level through domestic laws or rules. Where it is a transborder problem, bilateral or regional agreements would suffice. Where the environmental problem is global, a multilateral agreement is called for.

A corollary to the subsidiarity issue is the question of standards. At present, international trade rules allow the imposition of product standards which domestic and foreign producers need to meet to be able to sell at a particular market. Under GATT rules, countries may require that imported products meet the same product regulations as the domestic products and thus block imports of products which do not conform to such standards, with the proviso that such regulations can be challenged by exporting countries if they are unnecessary obstacles to trade.

However, a major issue of debate in the trade and environment literature is the circumstances under which countries can block imports based on the processes and production methods (PPMs) used. Current trade rules as agreed upon in the Uruguay Round's Technical Barriers to Trade Agreement allow the imposition of PPMs that affect the characteristics of the final product (i.e., product-related PPMs) but not nonproduct-related PPMs. The bias against the use of PPMs is that differences in PPMs and national endowments are the very basis of international trade. Equally important, most environmental problems are local; hence, there is no justification for imposing nonproduct-related PPMs on imported products when the production of the product does not at all affect the environment of the importing country. Again, drawing from the principle of subsidiarity, it is only in the case of global commons that PPM-based restrictions on international trade have merit, as exemplified by the Montreal Protocol.

Nevertheless, the call for trade sanctions by environmentalists includes the call for PPM-based sanctions. This is because PPM-based trade restrictions may be needed to enforce international environmental agreements. Moreover, there have been instances in the past when a few countries concerned with a particular environment problem were able to use trade restrictions, including PPM-based trade restrictions, in order to jumpstart the signing of an international environment agreement (e.g., restrictions in trade of chloroflourocarbons or CFCs prior to the Montreal Protocol) in the trade of endangered species (prior to their listing in the CITES) and in the trade of hazardous wastes (prior to the Basel Convention). The proposals on the banning of imports of tropical timber which is

not sustainably managed appear to be aimed primarily at jumpstarting the signing of an international environment agreement aimed at the adoption and enforcement of sustainable forestry management practices (see Stevens, 1994).

The challenge for the WTO is how to be more vigilant against "green protectionism" while being more open and flexible in accommodating environmental objectives within its framework. Otherwise, genuine environmental objectives may be used as an excuse for even stricter "bilateral" voluntary export restraints (VERs) and other bilateral trading arrangements on the pretext that there is no room within the GATT/WTO framework for the environmental agenda. A further weakening of a rule-based multilateral framework will disproportionately penalize developing countries which can exert less market or political influence (Quintos and Intal, 1994).

"The Greening of International Trade"[2]

Public concern for the environment started essentially as a local issue in the developed countries, focusing primarily on the connection between environmental problems and human welfare, especially the health effects of pollution. As such, government regulation of business was confined to the most obvious externalities—air and water pollution and environmental degradation of river systems, etc.—which were all local concerns. From the "first generation" issues involving obvious local environment concerns during the 1960s and early 1970s, the environment debate has moved since the latter 1980s to "third generation" environment issues involving transboundary and global commons issues. The"greening of international trade" arose primarily from this third generation debate which is underpinned by the realization of the interdependence of the world economy and the global ecology; hence, the focus on global warming, the ozone layer, and biodiversity.

"Third generation" environment issues call for increased international cooperation among countries. Hence, the surge in the IEAs signed during the past decade. The IEAs, however, are only as effective as the commitments of the signatory governments to the stipulations of the agreements, unlike the GATT agreements which have the WTO to monitor and implement them. For this reason, free

rider problems make collective action difficult, especially when information (monitoring) and other transaction costs are high, when gains to cooperators are diffuse and costs significant, and/or when the incremental contribution of any single country, by itself, is not crucial (Axelrod, 1984). Unfortunately, global environmental concerns like global warming meet these criteria.

The problems of employing collective international action to address global environmental concerns make using trade measures a desirable instrument for influencing the environmental policies of other countries. There is a call by many environmentalists for the use of trade measures in major importing countries on the imports of tropical forest products. However, this bias for using unilateral trade action for global environmental objectives coincides with the protectionist interests of industries in the developed countries that are vulnerable to increased competition from the developing countries (which tend to have a more lax implementation of environmental policies). It is argued that "environmentally lax" countries undermine international efforts to address global environmental problems at the same time that they unfairly edge out "eco-friendlier" countries whose industries are made to bear heavier environmental control costs. This is the essence of "green protectionism." Low and Safadi (1992) observe that economic interest groups in the United States (US) are more successful in lobbying when they move in concert with the environmental lobby. GATT/WTO rules and principles are precisely useful in this case in order to curb the proliferation of "green protectionism" or "protectionism garbed in green." Considering that there is a palpable movement toward freer trade in the world today as indicated by the expansion of the European Union toward an eventual European Space, the North American Free Trade Area (NAFTA), AFTA, and the APEC, it is likely that green protectionism will be a transitory phenomenon.

A more enduring impact of environmentalism is the changing preferences of consumers and voters primarily in the developed countries that can significantly influence international trading. For example, there has been a rise in eco-labelling which puts the burden of influencing production processes and product standards on the

consumers. Eco-labelling presumes that within a given class of products, not all of the products will place the same burden on the environment, taking into consideration the whole life cycle of the product (which includes production, distribution, use and disposal). Many Organization for Economic Cooperation and Development (OECD) countries including Germany, Canada, the Nordic countries, Japan, Austria, The Netherlands and Australia have eco-labelling programs (see Table 11.1). Similarly, recycling requirements have been promulgated in a number of countries. Finally, "green consumerism" is consistent with the toughening of product standards in many developed countries.

The rise of green consumerism and more stringent standards tends to increase the cost of exporting. The cost of gathering information on market requirements increases when the export markets are more heterogeneous. In addition, the costs of reputation building as well as searching for and bargaining with more diverse suppliers and markets will also increase. Even eco-labelling may entail higher costs for exporters than for domestic producers in the export markets precisely because of the information costs.

Table 11.1 Product Categories Subject to Eco-labelling

Countries	Products
Denmark	Paper products Textile Insulation materials
France	Paints and varnishes Household cleaning agents Solar systems
Italy	Refrigerators Packing materials Building materials (ceramic tiles)
The Netherlands	Footwear Cat litter
United Kingdom	Washing machines Dishwashers Bulbs Hair spray Organic additives

Source: EDS 1988 as reprinted in Quintos and Intal, 1994.

Eco-labelling has other implications for the international trading system. Eco-labelling schemes are normally designed by local producers, traders and nongovernment organizations on the basis of local environments. Thus, unless the process of eco-labelling is transparent, the scheme can become a barrier to international trade. Moreover, the proliferation of eco-labelling schemes that address primarily local environments make it more difficult to design equivalency, mutual recognition and certification schemes which are meant to reduce the transaction costs of market access. Finally, eco-labelling schemes tend to go for a life cycle (of a product) approach, thereby bringing into the international trading regime nonproduct-related PPMs. This is feasible at present because eco-labels are voluntary and undertaken by the private sector and they do not qualify as a "government measure" that can be challenged under WTO rules.

It is apparent that there is a need for greater transparency in the eco-labelling process (i.e., selection of products, selection of criteria, and the design of conformity assessment procedures). One proposal suggests that transparency involves giving the public notice about the proposed standard, technical regulation or conformity assessment procedure. Comments received should be considered when the final decision is made (see Reiterer, 1996).

The vulnerability of developing country exporters to the consumer preferences of developed country markets is exemplified by the case of the US Marine Mammal Protection Act or the tuna-dolphin issue. Although primarily aimed at Mexico, the tuna-dolphin issue forced the key canned tuna exporters from Thailand to shift their sourcing of tuna to "dolphin-friendly" sources in order to prevent the possibility of a consumer boycott. One leading Thai canned tuna exporter even launched an expensive public relations campaign in the US to reassure environmental groups and consumers that its products use tuna caught using "dolphin-friendly" techniques (Phantumvanit *et al.*, 1995). This indicates the vulnerability to and the need to be responsive to the changes in consumer sentiment in the developed countries because of the heavy dependence of the export sector of developing countries on developed country markets.

Another example of how exports in Southeast Asia are vulnerable is the Montreal Protocol under the Vienna Convention which targets significant reduction in the consumption of specified chloroflourocarbons (CFCs) and a freeze in the use of halons. The affected industries are the airconditioning and refrigeration industries where Malaysia has emerged as an exporter among the Southeast Asian countries, and semiconductors and other electronics products which constitute the biggest share of the exports of Malaysia, the Philippines and Thailand. The response of the leading export firms in the ASEAN has been to prepare a program of substitution with safer alternatives; otherwise, they will lose their export markets.

The greening of international trade will be further enhanced when the proposed ISO 14000 series of environment standards currently being finalized by a technical group under the International Organization for Standardization is adopted. The high interest generated by ISO 14000 stems from the strong possibility that governments and, more importantly, purchasers, contractors and business may require conformance to ISO 14000, thereby significantly affecting the parameters of international trading.

So far the greening of international trade has not had a significant impact on the export performance of the Philippines. At present, the commodity coverage of eco-labelling programs in the OECD countries is limited and involves products which the Philippines is not exporting or which do not constitute a significant share of the country's total exports. The Montreal Protocol has a potentially large impact on the Philippine electronics export industry. However, the industry has been reducing its use of CFCs and shifting to new techniques that are more environment-friendly. Thus, when 1999 comes it is likely that the industry will not be adversely affected by the implementation of the Montreal Protocol targets.

III. INTERNATIONAL TRADE POLICIES AND THE PHILIPPINE ENVIRONMENT

With or without foreign trade, the country needs to minimize the adverse environmental impact of production and consumption. The country's resource and environmental degradation is serious.

Table 11.2 presents indices of the quality of the Philippine environment based on selected indicators. The table indicates that deforestation and soil erosion are particularly severe. Metro Manila is one of the most polluted cities in the world.

Thus, more than the rise of environmentalism and its impact on the international trading environment affecting Philippine exports, it is the interaction of international trade and the Philippine environment that may be more pressing at present. The drive for freer trade needs to be coupled with improvements in environment management to ensure that trade liberalization is welfare enhancing. Equally important, the rapid deterioration of the Philippine environment during the past three decades makes it imperative that economic and trade policies not substantially compromise the country's already fragile environment.

During the past decade the country has been reducing tariffs and eliminating unnecessary nontariff barriers. This process is expected to continue until the tariff rate is more uniform, hovering around five percent by the year 2004. In effect, the country is in the midst of a major trade liberalization program. Does trade liberalization benefit *a priori* the country's environment? Will there be trade-offs between economic growth and environment protection? Will strengthened environmental protection policies adversely affect the country's export competitiveness, and therefore the country's export prospects? Have there been changes in the demands for environmental services in the country's production sectors over time? These are important questions to answer as the country moves toward freer trade, export competitiveness, and economic growth.

Pollution intensity of Philippine production and international trade

The pollution intensity of Philippine exports and imports for 1975 and 1990 is shown in Table 11.3. The classification of goods/industries by pollution intensity and health hazards is based on the technical classification used by the National Pollution Control Commission during the early 1980s. The table shows a marked change in the structure of Philippine exports. Specifically, there is a sharp decline in the share of highly pollutive (either hazardous or nonhazardous) exports during the period 1975-1990. In contrast,

Table 11.2. Indices of the quality of the Philippine environment

Environmental Component	Degree of Severity* in 1992	Average	Remarks**
Air			
PM (mg./Ncm)	2	1.67	
Sox (ppm)	1		
Pb (mg/Ncm)	2		
Water			
DO (mg/l)	1.5	1.875	Data was averaged only for Pasig River and Laguna Lake
BOD (mg/l)	2		
Fecal Coliform (contents/100 ml)	2		
Suspended Solids (mg/l)	2		
Terrestial Ecosystem			
Forest Cover (%)	3	2	
Rate of Deforestation (%)	2		
Percentage of threatened flora	1		
Land			
Soil Erosion	3		
Soil Degradation (%)	2	2.5	

Source: Delos Angeles *et. al.*, 1996. (Summarized from Table 1, Philippine Environmental Quality Indices Project.)

* The degree of severity is measured through a system of weights:

3 severe, when standards are exceeded by more than a factor of 2
2 moderate, when standards are exceeded by less than a factor of 2 or when the short-term standards are exceeded on a regular basis at certain times
1 low, when standards are normally met or when the short-term standards are exceeded occasionally

** Data for environmental indices are constrained by the following shortcomings: unavailable data for a specific environmental quality and limited geographic coverage of available data.

Table 11.3 Philippine exports and imports by pollution intensity

	% of Total Exports		% of Total Imports	
	1975	1990	1975	1990
Highly Pollutive/Extremely Hazardous	2.3	5.0	32.5	24.4
Highly Pollutive/Hazardous	31.3	10.4	14.8	19.4
Highly Pollutive/Non-Hazardous	17.4	6.5	4.5	4.6
Pollutive/Extremely Hazardous	0.3	2.1	1.7	5.3
Poilutive/Hazardous	17.7	18.9	34.5	19.7
Pollutive/Non-Hazardous	0.3	1.3	0.9	1.3
Nonpollutive/Hazardous	21.9	11.2	8.1	9.2
Nonpollutive/Non-Hazardous	8.9	44.6	3.2	16.2

Source: Intal *et al.*, 1994 Appendices 1.a and 1.b.

there has been a dramatic increase in the share of nonpollutive and nonhazardous exports during the same period. The changes in the composition of the country's imports are less marked. Nevertheless, the country's imports have also shifted more toward the nonpollutive and nonhazardous group although the share of highly pollutive imports remained close to one half of all total imports in 1990.

Table 11.4 presents the pollution intensity of domestic industries using 1992 data, based on the estimates of the Environment and Natural Resources Accounting Project. Pollution intensity measures the pollution abatement cost that would reduce

the existing level of pollution to a nondamaging level, assumed to be 10 percent of total uncontrolled emissions or, for agriculture and forestry, from surface runoff. The table shows that it is the natural resource intensive industries, i.e., mining, forestry, agriculture, livestock and poultry, which have the highest pollution intensities. The industries with the lowest pollution intensities tend to be the labor intensive manufacturing industries.

Table 11.4 suggests the reasons behind the reduction of the pollution intensity of Philippine exports and imports. Specifically, the decline stems primarily from the sharp decline in the share of primary exports and the sharp rise in the shares of electronics products and garments which are both relatively labor intensive manufactures and less pollutive. The significant increase in the share of nonpollutive/nonhazardous goods in the country's total imports can be explained by the heavy dependence of the country's electronics and garments manufacturing industries on imported raw materials which are themselves generally relatively less pollutive.

Trade liberalization and the Philippine environment.

Simulations using a simple static input-output type of model linked with the tariff rates and the trade balance were used to determine *a priori* whether trade liberalization is beneficial to the country, taking into consideration the effects on the environment (see Intal *et al.*, 1994; Medalla and Intal, 1996). The simulation scenarios assume either a 50 percent across the board reduction in tariff rates or the setting up of a uniform tariff rate of five percent. In addition, the scenarios assume either a fixed exchange rate or flexible exchange rate regimes.

The summary results are shown in Table 11.5 which indicates that drastic across the board tariff reduction or a uniform low tariff regime results in lower output and higher overall pollution intensity when the trade liberalization is undertaken under a fixed exchange rate regime. This is to be expected because other things being equal, tariff reduction without exchange rate correction will result in lower outputs of the more protected industries. The rise in the overall pollution intensity of the Philippine economy stems from the increase in the share of agriculture and natural resource-based

Table 11.4 Pollution abatement cost ratio by sector (in percent)

PSIC	INDUSTRY & PROCESS	AC/Q
11-13	AGRICULTURE	1.676
11	Agri. crops production	2.340
12	Livestock, poultry, etc.	0.538
13	Agricultural services	0.030
14	FISHERY	0.131
151-159	LOGGING & OTHER FORESTRY ACTIVITIES	28.838
211-212	GOLD & OTHER PRECIOUS METALS	9.117
213	COPPER ORE MINING	7.808
214-219	OTHER METALLIC MINING	34.086
223	STONE, SAND, & CLAY QUARRYING	1.288
221,222,229	OTHER NONMETALLIC MINING & QUARRYING	6.916
311-312	FOOD MANUFACTURING	0.293
313	BEVERAGE MANUFACTURING	0.628
314	TOBACCO MANUFACTURING	0.109
321	TEXTILE MANUFACTURING	0.386
322	WEARING APPAREL	0.125
323-324	MFR. OF LEATHER & LEATHER PRODUCTS	0.480
331	MFR. OF WOOD & WOOD PRODUCTS	1.273
332	MFR. & REPAIR OF FURNITURE	0.298
341	MFR. OF PAPER & ALLIED PRODUCTS	0.660
342	PRINTING, PUBLISHING & ALLIED INDUSTRIES	0.381
351,352 & 356	MFR. OF CHEMICALS & PLASTIC PRODUCTS	0.291
353-354	PRODS. OF PETROLEUM, COKE AND COAL	0.045
355	RUBBER PRODUCTS	0.230
36	MFR. OF NONMETALLIC MINING	0.980
371	IRON & STEEL BASIC INDUSTRIES	0.350
372	NON-FERROUS METAL	0.275
381	MFR. OF FABRICATED METAL PRODUCTS	0.228
382	MFR. OF MACHINERY, EXCEPT ELECTRICAL	0.805
383	MFR. OF ELECTRICAL MACHINERY, ETC.	0.110
384	MFR. OF TRANSPORT EQUIPMENT	0.270
385 &390	OTHER MANUFACTURING INDUSTRIES	0.131
386	MFR. & REPAIR OF METAL FURNITURE & FIXTURES	0.453

Source: Medalla and Intal, 1996.

Note: AC/Q is the ratio of Abatement Cost (1992 in 1988 prices) and Total Output from the 1988 I-O Table (except for sectors 213, Copper ore mining, and 214 to 219).
Other metallic mining: Output used are from the 1988 Census of Establishments).

industries which are more pollutive than the hitherto more protected industries. Despite the increase in the pollution intensity, the decline in output also results in a lower level of pollution as indicated by the reduction in pollution abatement costs.

The results in Table 11.5 indicate that when trade liberalization is accompanied by a compensating real peso depreciation, total output increases because of the improved allocation of resources and the "protective" effect of the peso depreciation on the import substituting industries. In addition, the overall pollution intensity of the economy declines where there is across the board proportionate reduction in tariff rates. Output growth is highest in the case of the uniform low tariff scenario but at the expense of a mild increase in the overall pollution intensity of the Philippine economy. Table 11.5 also indicates that because of the increase in output arising from the trade liberalization-cum-real peso depreciation, the total level of pollution will also be higher. Thus, there appears to be some trade-off between economic growth and environmental protection. The challenge is choosing the development and growth path that imposes the least cost to the environment at every given level of income.

In evaluating which of the four cases is the most welfare enhancing, Medalla and Intal (1996) use the value of total output net of the total environmental cost as the measure of national welfare. The results indicate that trade liberalization through the adoption of a uniform low tariff and accompanied by real peso depreciation is the most welfare enhancing option that the government can take, other things being equal. The absolute level of environment cost would be less if the unit pollution intensities of the industries are reduced, which can be done through technical change, investment, appropriate pricing, etc. It is in this context that trade liberalization combined with appropriate exchange rate and macroeconomic policies as well as a better environment policy regime, would be welfare enhancing.

It may be noted that the analysis above is static. There may be dynamic gains from trade liberalization with a positive impact on the environment. Trade liberalization and economic growth encourage newer investments which are likely to utilize newer embodied technologies. Because the capital goods come mainly from

Table 11.5 Impact of trade liberalization on the Philippine environment

	Base	A	B	C	D
OUTPUT					
% change with respect to base		-5.17	2.87	-8.96	4.02
POLLUTION INTENSITY					
All	1.91	2.09	1.89	2.27	1.94
Manufacturing	0.3405	0.3401	0.3401	0.3395	0.3394
TOTAL ABATEMENT COST (in billion pesos)	5.26	5.17	5.46	5.14	5.65
NET OUTPUT (output less abatement cost, in billion pesos)	270.3	242.3	282.8	221.1	285.6

Source: Medalla and Intal, 1996.

A refers to post trade reform output: changes in output after a 50 percent proportional decrease in effective protection rate (EPR) from 1985 levels, given a fixed exchange rate.

B refers to post trade reform output: changes in output after a 50 percent proportional decrease in EPR from 1985 levels, given a flexible exchange rate.

C refers to post trade reform output: changes in output given a uniform EPR of 50 percent across all sectors, from 1985 levels, given a fixed exchange rate.

D refers to post trade reform output: changes in output given a uniform EPR of five percent across all sectors, from 1985 levels, given a flexible exchange rate.

Base is 1983.

the developed countries, they are geared for stricter environmental standards and are likely to use resources more efficiently in economic and ecological terms. Export-oriented industries would have to cater to the demands of the industrialized countries which constitute the major share of the Philippine export market and therefore would have to comply with the relatively strict environmental standards in those markets.

Cost internalization and competitiveness

The foundation of sound environmental policy is that the social cost of production and consumption externalities (e.g., pollution) effectively influences the supply decisions of producers and expenditure decisions of consumers, and therefore, of market prices. In this way, the cost of pollution abatement may help determine the resulting market prices.

Cost internalization is the essence of the so-called "Polluters Pay Principle" (PPP), the "oldest, most durable and arguably most important doctrine bridging environmental and trade policies" (Pearson, 1994). The PPP emphasizes that the financing of the costs of pollution abatement to achieve "appropriate" levels of pollution (where the marginal social cost of pollution is equal to the marginal social cost of abatement) must be borne by the polluters themselves, except for limited and transitory government assistance to address regional imbalances and jumpstart the new environmental measures as well as for R&D expenditures on pollution abatement technology. The PPP has become the official policy in the European Union and the OECD but it is not explicit in the GATT, GATT Subsidies Code and the Uruguay Round agreements. Splicing the PPP to the GATT may best be done by convincing GATT member countries of the advantages of voluntary adherence to the "Polluters Pay Principle." (see Pearson, 1994)

A key concern related to cost internalization through the adoption of such policies as the PPP or the Users Pay Principle (UPP) (its more difficult-to-implement analogue in the natural resources area) is the impact of cost internalization on the international competitiveness of the country's industries. Intal, de

los Angeles, Medalla and others (1994) have examined whether or not the country's comparative advantage in an industry is maintained because of cost internalization. The study focused on a few export sectors and the import substituting textile industry sector. The results of the analyses suggest that in general cost internalization will ***not*** have a significant adverse impact on the country's comparative advantage in the selected export industries. However, cost internalization would further worsen the country's incentive structure against the export sector.

The Intal, de los Angeles, Medalla *et al.* study used the domestic resource cost of earning or saving a dollar of foreign exchange as the basis for evaluating whether or not cost internalization has significant adverse impact on the country's competitiveness. There is a concern, however, that implementing cost internalization (through the implementation of the PPP, for example) may have a significant adverse impact on competitiveness, taking into consideration the prices of factors of production (e.g., wages) and labor productivity in the Philippines *vis-á-vis* those in competitor countries. The comparison with other countries is particularly more salient at present because of the failure of the Philippines to improve its productivity significantly during the 1980s and early 1990s, in sharp contrast to the significant increase in the labor productivity of other competitor countries.[3]

The results of the Intal, de los Angeles, Medalla *et al.* study and the comparison of competitiveness with competing countries in the region pose some dilemma for environmental policy in the country. On the one hand, the Intal *et al.* study suggests that the country can accommodate cost internalization as long as the distortions in the economy, especially the market for factors of production, are corrected. In contrast, the comparison with other countries in the region indicates that the international competitiveness of the Philippines deteriorated during the 1980s and early 1990s, implying that cost internalization would further lower the country's international competitiveness.

Considering that the Philippines needs to deal with the environment problem in the country head-on under an appropriate environment policy and pricing regime, cost internalization remains

the appropriate course of action to take. In effect, the country needs to look elsewhere (other than an implicit export subsidy through the deterioration of the environment) for improved international competitiveness. Specifically, the country needs to pursue further reforms or deepen current reforms both at the macroeconomic, institutional, and support services levels for the country's productivity to improve much more significantly, the underlying factor cost structures to become more realistic, and the allocation of resources to become more efficient. With improved productivity and macroeconomic management, it is likely that the cost internalization of the externality effects to the environment would not significantly worsen the country's international competitiveness.

IV. ADJUSTING TO THE NEW TRADE AND ENVIRONMENT PARADIGM

Meeting the challenges of the new trade and environment paradigm requires that the Philippines exercise greater vigilance on the developments in the foreign front and continue the pricing and institutional reforms domestically in order to make the economy more efficient, the growth process more equitable, and the negative environment impact of economic growth manageable.

To address the growing green consumerism in the world, the rise in environmental regulations in the foreign markets, and the likely implementation of the ISO 14000, the country may need to:

- invest in more extensive gathering of information on and analysis of the international developments on the trade and environment nexus;

- encourage export-oriented firms to undertake environment management investments to meet the rising standards in the foreign markets (e.g., the serious attempts of the country's semiconductor export industry to meet the Montreal Protocol goals);

- disseminate locally the ISO 14000 and the various environment-related rules and regulations as well as standards and eco-labelling in other countries;

- strengthen local institutions that can do certification requirements, similar to what Malaysia has been doing in strengthening Standards and Industrial Research Institute of Malaysia (SIRIM);

- support work at the WTO for the prevention of indiscriminate use of PPM-based trade restrictions in the world; and

- press for greater transparency of the eco-labelling programs, greater involvement of other countries in the process of setting criteria and conformity assessment procedures for eco-labelling, acceptance of equivalent standards or regulations, nondiscriminatory treatment against imports, mutual recognition, and technical assistance to help the country cope with the surge in eco-labelling.

A long list of policy, institutional and operational challenges still face the Philippines at the local front. The agenda for action can be drawn from the Philippine Strategy for Sustainable Development being finalized at present by the AGENDA 21 project, and various policy papers written by both local scholars and foreign and domestic consultants. No attempt is made here to put together the long list of recommendations. Nevertheless, it is useful to highlight some of these.

The Philippines needs to:

- improve the country's industrial environmental management framework and practice. Currently, the key regulatory tool of the Department of Environment and Natural Resources (DENR) is the use of cease and desist orders (CDOs). The DENR is developing an innovative industrial management framework which includes the use of pollution management appraisals (PMAs) in industry, market-based instruments, increased reliance on decentralized, participative monitoring communities and private groups, more extensive use of private

laboratories, etc. The PMAs emphasize waste minimization and process improvements rather than end-of-the-pipe technologies. In addition, the PMAs are meant to be social contracts on programmed pollution reduction and the meeting of standards over time. The DENR may need to push harder the dissemination of information on, and the implementation of, the industrial environmental management framework set out above.

- move toward more appropriate pricing of the use of natural resources (e.g., water) and the implementation of property or user rights reforms particularly in the uplands (beyond the social forestry contracts) and municipal fishing grounds. More investments by the private sector and communities to undertake reforestation and agroforesty in the uplands should be encouraged.

- encourage private investments in common service facilities for environmental management, especially for small and medium scale industries and for toxic materials. The relocation of selected industries (for example, the textile finishing industry and the leather tanning industry, which are both water pollutive) to selected sites with well provided common service facilities, should also be encouraged.

- further streamline the process of IEAs in order to reduce the transaction cost of complying with the IEA requirements. A related move is the review of standards in the country to see whether or not they are reasonable because non-compliance with the standards appears to have been a source of harassment of local industries especially by local politicians.

- invest in water and sanitation infrastructures because the major source of water pollution in the urban areas of the country are the households.

To sum up, the debate on the trade and environment linkages shows that the best way of adjusting to the new trade and environment paradigm is to pursue further economic policy reforms to ensure a

more efficient and internationally competitive economy, in tandem with a stronger environmental policy and institutional reforms to strengthen environmental management in the country.

NOTES

[1]This subsection draws heavily from OECD (1994).

[2]This subsection is taken largely from Quintos and Intal (1994).

[3]In comparisons of the unit labor cost in efficiency terms (adjusted for the productivity of labor) of several countries in the Asia Pacific region, Golub (1995) found that the unit labor cost of the Philippines has in fact risen significantly relative to the United States (US) during the 1972-1990 period, primarily because of the much larger rise in labor productivity in the US as compared to a decline in the labor productivity in the Philippines together with the appreciation of the Philippine peso. In effect, the country's international competitiveness declined during the 1970s and 1980s.

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COMMENTS

*Antonio Laviña**

Let me begin by addressing the last point raised by Dr. Ponciano Intal, Jr. about whether we are shifting toward a market-based system. My answer is a categorical yes. We are at the threshold of consolidating and streamlining our policies based on the experience of the last ten years. We are shifting from a command-and-control approach to environmental and natural resources management to a community-based approach which is also market-based. We hope that during the watch of the incumbent Department of Environment and Natural Resources (DENR) Secretary Victor Ramos we shall have been able to institutionalize a clear and comprehensive framework, hopefully through legislation. There is a pending bill on sustainable forestry management and a pending environmental code that we are pushing for. Both reflect the movement away from the command-and-control approach. We are also trying to reconcile the contradictions between market-based approaches as understood in developed countries and community-based resource management approaches with which we have had a lot of experience. There has been as yet no comprehensive attempt to integrate these two approaches.

I agree that from an international point of view there is really no theoretical conflict between trade rules and environmental rules. The rules on how to deal with these are quite clear in the Uruguay Round and WTO agreements. However, as Dr. Intal pointed out, we do have some problem areas. The tuna/dolphin issue has been mentioned. Lately the issue involving Venezuelan fuel has come up in the United States. The US Clean Air Act seems to discriminate against oil coming from Venezuela.

The real problem at the international level has to do with the basis of the standards. When do you say that these standards are really based on legitimate environmental concerns rather than being merely protectionist? The question, for example, on the nature of scientifically-based standards is really problematic. I think that scientific standards are not as problematic for trade negotiators as they are for environmental negotiators. I have had some experience with environmental negotiations and we fight over a term like "best available science" for six to seven hours. And often by way of compromise, we agree upon "best available scientific knowledge" but

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only after putting in qualifiers such as "cultural appropriateness" and other relevant social and economic information which open it up to a lot of other things. Hence, arriving at a commonly acceptable basis for environmental standards is really very difficult to achieve in international negotiations.

I used to say that the Mexico-US conflict on tuna and dolphin protection was simply because of the TV show "Flipper" which Americans are very fond of. I say this as a joke because I don't know this for a fact. People may feel very strongly about the environment for some objective scientific reasons or because of religion or culture. This has to be respected. But these differences in motivation will always create problems no matter how clear the rules are.

I would like to point out that in the Philippines, we are now being confronted with issues relating to biological diversity. This is quite important to us but it may be in conflict with our WTO commitments. An example is our move to regulate bioprospecting activities in the Philippines, that is, the collection of genetic materials for development into commercial products. The DENR, DOST and other government agencies are in the process of putting together the implementing rules and regulations of Executive Order (EO) No. 247 which provides a regulatory framework for bioprospecting. We are trying to come out with rules consistent with WTO prescriptions, but the possibility of a conflict of interest between the two is very real. Take, for example, intellectual property rights. EO 247 rules that collectors of endemic species must sign an agreement with the Philippine government to the effect that the technology used to develop the commercial product must be given for free, or that a Philippine institution must be entitled to royalties. Having been instrumental in drafting that EO, I have gotten an avalanche of E-mail from law firms all over the world saying this is a violation of TRIPS. Of course, my answer is no because the basis for this is entirely outside the purview of the trade round. But this is arguable. When it goes to the WTO panel, I am not sure if we will be upheld.

Another issue which needs to be discussed more extensively is the impact of our environmental policies on our comparative advantage *vis-á-vis* our neighbors, particularly the ASEAN countries and other developing country members of APEC. We did a study for

the Foreign Service Institute on the environmental impact assessment (EIA) systems of four countries in the region and we found out that the Philippines was the most advanced not only in environmental impact systems, at least at the policy level, but also in almost all other areas of environmental law. We are the most advanced in the sense that we are the most strict in terms of policy. Self-imposed environmental conditionalities can create a real barrier or disincentive to investment when strictly enforced.

However, our conclusion is that we are not that comparatively disadvantaged for the simple reason that we are not implementing our laws as strictly as we should. As long as there is no public outcry, environmental impact assessment in the Philippines is really just a paper process for the purpose of bureaucratic compliance. I hope my colleagues from the environment bureau will not take offense at this. When there is major opposition to controversial projects, the EIA process begins to work at first, but in time becomes entirely politicized. So we must find the right balance. But I also agree that good environmental policies need not necessarily mean a diminution of our comparative advantage.

Next, let me pose some challenges. What is clear from Dr. Intal's paper and from the literature is this: If we are to adjust our environmental and natural resource management system to the emerging global trade system, then we must move toward market-based approaches. The DENR is definitely moving in this direction, particularly toward negotiated standards. Actually, the best way to input locally what is happening at a global trade level is to negotiate with industry. Our problem in this regard is preparing the negotiating position on the government side and preparing rules of engagement on the enforcement side.

When we negotiate standards with industry and these are agreed upon, we must be prepared to enforce the standards very strictly. Industries must also be convinced that we intend to do just that. Take the oil companies, for example. Secretary Ramos had to say no to their request for a delay in the reduction of sulfur content precisely because that was a negotiated standard and we cannot keep on postponing enforcement until election time comes because then you have to start the process all over again. I am a member of

the Pollution Adjudication Board and it is amazing how sometimes companies are given three to four to five years to comply with company-specific negotiated standards. If we keep on dithering, we will never be able to have an optimum environmental management system in place.

I also agree with Dr. Intal that a complete evaluation of resources is essential. An appropriate costing of environmental goods has to be made. Another challenge of course is harmonization. My greatest fear is that if we begin enforcing our environmental laws strictly, this might lead to a diminution of our comparative advantage *vis-á-vis* our competitors. So, it is to our interest to harmonize our environmental laws with those of our neighbors and trading partners.

Finally, let me go back to the point that to ensure that market-based approaches to environmental and natural resources management will work in the Philippine setting, we must develop community-based resource management systems at the same time. Better still, community-based approaches must already be in place before we adopt market-based approaches. The market is not a level playing field, especially in natural resources management. The playing field must first be levelled. Hence, our priority and emphasis in natural resources management is to empower the private sector, that is, communities rather than industry. Later on, when communities are able to negotiate on even terms with industry, we can apply a full-blown market-based system. The fact is most communities are not in a position to do that now. With respect to environmental management, a community-based system has a higher priority. A community-based system is really more for monitoring and enforcement rather than for control and management.

Part 3
INSTITUTIONAL AND POLICY CHALLENGES

12. Economic Interdependence and Macroeconomic Coordination

*Cayetano W. Paderanga, Jr.**

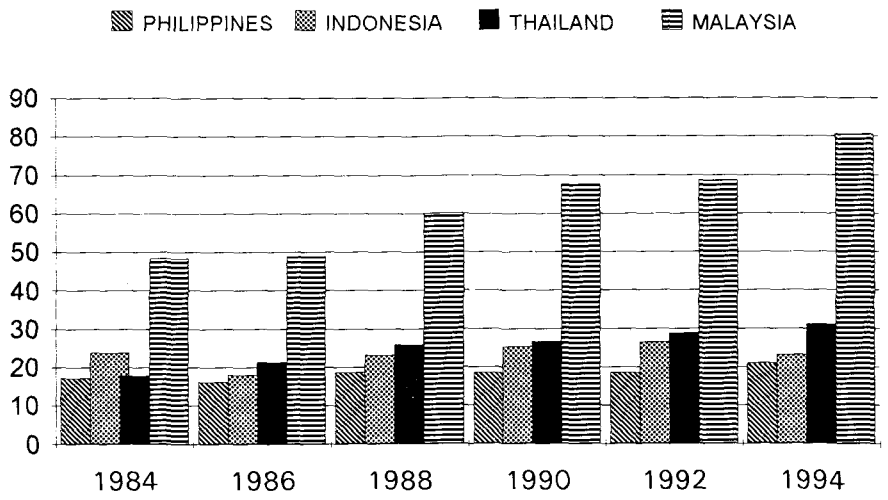
I. THE NEW ENVIRONMENT

The world is rapidly becoming more economically integrated. This was announced with dramatic flourish by the dismantling of the Eastern European socialist economies at the turn of the decade and the signing of the World Trade Organization (WTO) accord in Marrakesh, Morocco in 1994. Rather than a drastic upheaval, the process has been one of continual opening of individual country markets or of groups of countries (in spite of the impression given by periodic announcements of increasing protectionism and calls for protection by certain sectors). Figures 12.1(a) to 12.1 (c) show total trade, exports and imports in proportion to gross domestic product (GDP) for four countries of the Association of Southeast Asian Nations (ASEAN) from the 1980s to 1990-94.

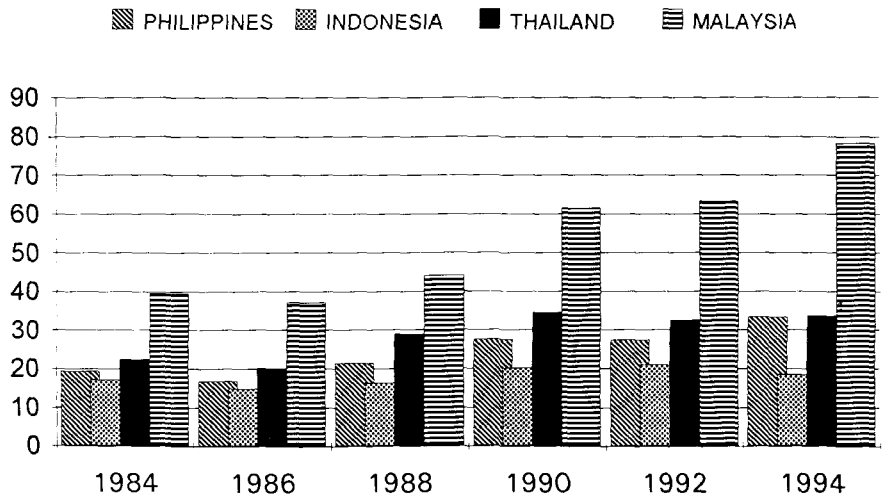
This increased integration in the goods market has been matched by a parallel integration in financial markets. Figure 12.2, for example, shows the increasing flow of capital to developing countries. From the 1960s to 1993, there has been almost a hundredfold increase in annual flows. Table 12.1 shows the average ratio of capital flows to GDP for some developing countries during the 1980-89 period. Figure 12.3 shows the more recent trends of the gross capital flows to GDP ratio. Equity market capitalization has also increased along with increasing financial flows. Figure 12.4 charts the trend in four ASEAN countries. This has strengthened

*The author would like to thank Ponciano Intal, Takeshi Nohara, Robert Scollay, and Maria Lourdes Sereno for valuable comments and Jose Antonio Tan III for research assistance.

Figure 12.1. Ratio of exports, imports to GDP in selected ASEAN countries, 1980-1994 (in percent)



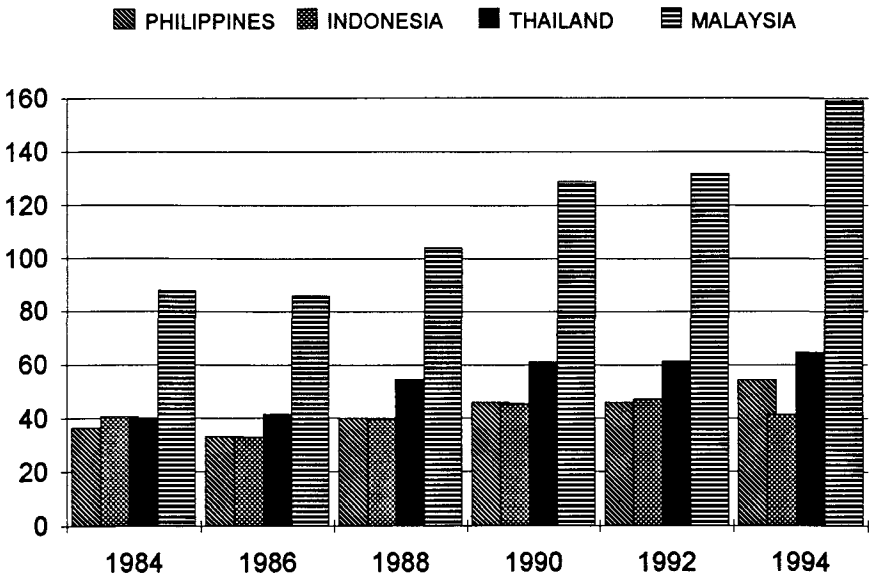
(a) Exports



(b) Imports

Source: Appendix Table 12A.1

Figure 12.1 (c). Ratio of total external trade to GDP in selected ASEAN countries (in percent)



Source: Appendix Table 12A.1

the integration of the countries' securities and equity markets with the international financial markets. A similar inference can be drawn from Table 12.2 which shows the inflows of foreign direct investment or FDI (as % of GDP) for selected Asian and Latin American economies.

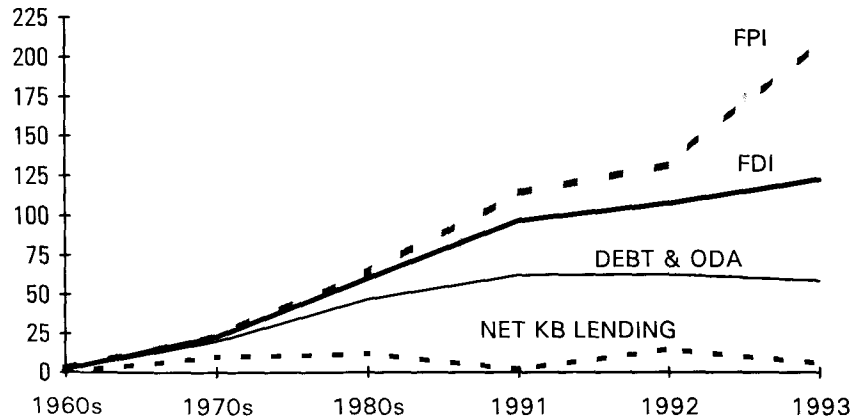
These data indicating an increasing integration of world financial markets have raised fears that countries have become vulnerable to policies and events happening outside their borders and beyond their control. There is an increasing feeling of vulnerability to external events and policies undertaken by authorities not subject to domestic influence. There is also a feeling that policy coordination can increase the welfare of all participating countries.

Table 12.1. Gross capital flows to GDP ratios*

	1980-83	1984-86	1987-89
Philippines	8.94	9.77	6.09
Malaysia	9.10	10.10	8.88
Indonesia	4.96	4.45	7.15
Thailand	6.20	6.45	6.04
Singapore	21.15	22.99	23.07
South Korea	5.42	5.27	4.25
India	1.50	1.51	2.31
Pakistan	3.58	3.46	4.58
Bangladesh	3.79	3.77	3.57
Sri Lanka	9.15	9.14	10.37
Chile	16.70	24.18	13.63
Uruguay	8.04	4.57	9.65
Venezuela	6.48	3.36	9.04
Mexico	9.01	9.05	6.98

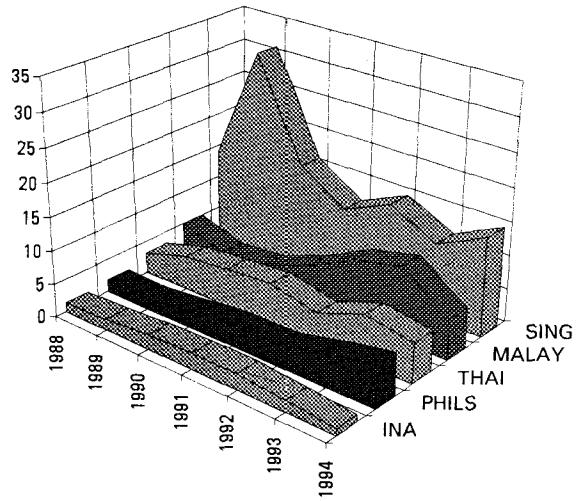
Source: Montiel (1994): *3-year averages, in percent.

Figure 12.2. Selected capital flows to developing countries (in US$ billion)



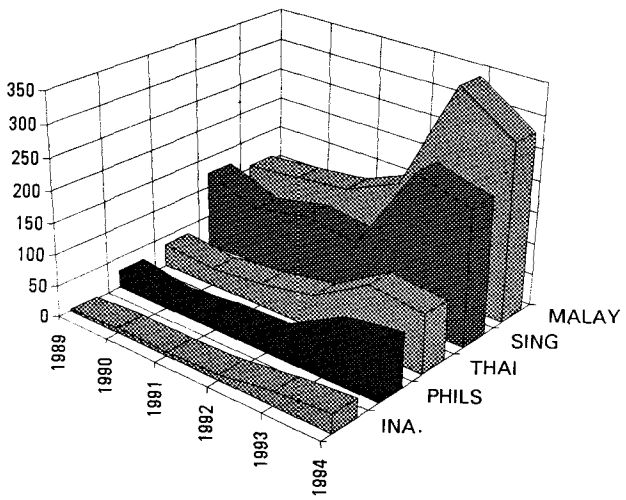
Source: Appendix Table 12A.2

Figure 12.3. Ratio of gross capital flows to GDP in selected ASEAN countries (in percent)



Source: Appendix Table 12A.1

Figure 12.4. Ratio of equity market capitalization to GDP in selected ASEAN countries(in percent)



Source: Appendix Table 12A.3

Table 12.2. Ratio of foreign direct investment to gross domestic product (selected years)

	1970	1980	1990
Asia			
South Korea	0.82	0.01	0.30
Taiwan	0.01	0.10	3.35
Singapore	4.91	9.36	13.90
Thailand	0.61	0.58	2.96
Malaysia	2.24	3.74	5.50
Indonesia	1.44	0.17	0.90
Philippines	-0.37	-0.32	1.21
India	0.01	N.A.	N.A.
China	-	0.16	0.96
Latin America			
Chile	-0.97	0.76	2.14
Argentina	0.05	0.43	1.93
Mexico	0.84	1.10	1.11
Brazil	0.34	0.80	N.A.
Colombia	0.60	0.46	1.22
Peru	-0.97	0.13	0.09
Venezuela	-0.17	0.08	0.93

Source: Urata (1994)

II. ECONOMIC COORDINATION

A. Interdependence among countries

Recent phenomena in international economic relations have led to calls for economic policy coordination. But while the gut impression of deeper international relationships and heightened vulnerability is easily grasped, the bases and details of economic coordination require more specification. One proposal proceeds from the increased vulnerability of economies to events happening outside their control. With increasing global interaction in finance and communication, the impact of external events is both stronger and more difficult to anticipate (and absorb). Economic policy coordination (and cooperation) can help countries avoid or moderate the adverse impact of external events through preemptive and preventive macroeconomic cooperation or, at least, consultation.

The other thrust for economic policy coordination stems from the increase in economic interaction because of increased trade, finance, communication and other channels mentioned earlier. Increased commerce among countries brought about by worldwide liberalization and the deepening of multilateral trade agreements, especially the WTO, provide opportunities for interdependent countries. Cooperative or jointly determined macroeconomic actions can be coordinated for maximum effectiveness. Strictly speaking, it is only when the openness and the size of the economy are such that it is itself affected by the impact of its own actions on the rest of the world that the openness becomes interdependent (Cooper, 1984). There are two ways this may operate for small countries like the Philippines: first, if, as in the present world environment, countries warily watch each other and immediately institute countervailing actions against those which they perceive to have an adverse impact on themselves; and second, if the macroeconomic action's impact is confined to a smaller area so that neighboring countries, even if small, begin to have strong interdependent relationships.[1]

Richard N. Cooper (1985) distinguishes four types of interdependence. **Structural interdependence** refers to the situation where two or more economies are highly open with respect to each other that economic events in one strongly influence economic events in the other. This interdependence implies that each country will have a strong interest in information about the structure of the other economies. The ASEAN Free Trade Area (AFTA), for example, is expected to lead to close interdependence among its members. That is why there is intensifying interest in what the other member countries are doing.

Everybody expects increased structural interdependence from the implementation of AFTA. What is not so obvious is how each member, even as of now, can be watchfully conscious of the real effective exchange rates (REERs) of every other member because they are in many cases competing for the same markets and also thinking of selling to each other. This is **interdependence among the objectives** of macroeconomic policy. That is, one country is significantly affected by the attainment of targets in another country.

There may also be high **interdependence among the exogenous disturbances** to a group of countries. If disturbances exogenous to a group of countries are highly correlated, these disturbances may intensify the externalities due to high structural interdependence. Unfortunately, the same tendencies which increase structural interdependence (such as openness, global financial integration, etc.) may also increase the correlations among exogenous shocks to these economies.

Finally, all of the interdependencies mentioned above give rise to **policy interdependence**. As countries become aware of the externalities among them, they may start manifesting strategic game behavior when deciding on macroeconomic policy. An international version of the prisoner's dilemma would be counter-productive for all countries. The "beggar-thy-neighbor" attempts of countries during the Great Depression immediately come to mind. On the other hand, the externalities can also be exploited in order to magnify the benefits (or lessen the cost) of policies implemented in coordination with other countries.

All of the foregoing dimensions of interdependence have led to increasing calls for economic coordination or cooperation.

B. The need for policy coordination

Interdependence among countries imposes significant externalities or spillover effects on other countries. Policy actions by some countries will have effects on other economies. In a departure from the largely self-contained economies in previous times, countries base their policy decisions on factors that include those which are beyond their control. Larger countries which exercise some degree of influence over prices, including crucial interest and exchange rates, may manipulate such prices to their own advantage and at the expense of others. Thus, coordination of some form or another becomes a facilitating mechanism for internalizing these externalities (Frenkel *et al.*, 1988).

The other argument given for coordination is the presence of international public goods (Frenkel *et al.*, 1988).

The argument for economic policy coordination under the conditions mentioned above is not conclusive. There are costs to coordination as will be discussed below. And as in the classical case of markets for commodities, the optimal choice for an individual country depends on the costs and benefits of leaving things in the uncoordinated situation (the analogue of leaving things to the market) or committing to the disciplines of economic policy coordination. This raises a third alternative (i.e., besides coordination and *laissez faire*): the acceptance of a common set of rules designed to reduce or make visible the externalities that countries impose on each other.

Once we accept the conclusion that the uncoordinated environment is untenable, it is the third alternative which can be the benchmark against which coordination is compared. Grant, for example, the case where uncoordinated national policy making imposes costs which overwhelm the benefits of independent policy or decision making. One may choose to lessen the cost of externalities by accepting mutually agreed upon rules for

everybody to follow. Within these rules, countries can implement policies based on (residual) national conditions alone. The rules may lessen the externalities enough such that the net benefits of this "constrained decentralized policy making" may be superior to closer coordination among countries.

In a way, the combination of the Bretton Woods Agreement on the International Monetary Fund (and the World Bank) and the General Agreement on Tariffs and Trade (GATT) is an application of the "constrained decentralized system." Countries accepted some restraints on their ability to structure trade and tariff policies and adhered to a system of generally fixed exchange rates in the belief that these restraints would expand world trade and would benefit everybody. The unprecedented growth in the world economy in the last 40 years is taken by most observers as an indirect validation of that belief. It is also a model of how some other version of a constrained decentralized policy system can operate. Table 12.3 shows the results of the study of Glenn Harrison, Thomas Rutherford and David Tarr (1995) indicating the short-term and long-term welfare effects of increasing openness and global integration. Table 12.4 focuses on the welfare effects of the agricultural reform component of the recent Uruguay Round.

The general observation is that the increasing openness in trade through the WTO and the progressive globalization of the financial system require more coordination. The question for a country like the Philippines is whether a deepening of the constrained decentralized system (i.e. additional rules but with essentially the same mechanism) is superior to a system with more formal (and periodic) coordination.

C. Methods of policy coordination

Coordination has many levels and dimensions. Several aspects of economic policy can be the objects of coordination. Cooper (1984) identifies three. First, goals can be coordinated. There is a presumption that if goals can be coordinated, the relevant macroeconomic policies will automatically be coordinated. Goals can be competitive, common or related to one another only through general economic interdependence. Sometimes goals are directly competitive

Table 12.3. Welfare effects of the Uruguay Round
(in US$ billion*, %)

	Short-term Effects		Long-term Effects	
	US$ B	% of GDP	US$ B	% of GDP
North America	14.6	0.4	29.3	1.0
EU	39.3	0.6	0.9	0.7
Non-EU Europe	4.0	0.2	10.0	0.8
ANZ	1.6	1.4	4.7	4.7
Japan	16.9	0.5	22.7	0.6
China	1.3	0.3	2.0	0.5
East Asian NIEs	4.0	0.3	0.5	1.9
ASEAN	7.4	10.2	23.3	27.9
Philippines	0.9	1.6	2.4	4.4
Latin America	3.6	1.0	13.6	4.5
Sub-Saharan Africa	-0.3	-0.2	-0.7	-0.4
Midde East & North Africa	-0.3	-0.1	1.5	0.3
South Asia	3.7	1.0	6.7	2.0
Developing countries	19.4	0.4	55.2	1.2
Industrial countries	76.7	0.4	115.4	0.6
World	96.0	0.4	170.6	0.7

Source: Appendix Table 12A.4

* In 1992 US dollars.
Key :
EU = European Union 1994 Members
ANZ = Australia and New Zealand
East Asian NIEs = S. Korea, Taiwan, Hongkong
ASEAN = Indonesia, Malaysia, Singapore, Thailand, Philippines

Table 12.4. Welfare effects of agricultural reform (in US$ billion)

	All Distortions*	Export Subsidies	Production Subsidies	Import Distortions
North America	1.9	0.0	1.8	-0.2
EU	28.5	11.5	17.8	-1.2
Non-EU Europe	2.2	-1.2	2.4	0.5
ANZ	1.0	0.2	0.2	0.5
Japan	15.2	-2.2	-0.5	17.7
China	-0.6	-0.2	-0.1	-0.3
East Asian NIEs	5.2	-0.1	0.0	5.0
ASEAN	3.3	-0.1	0.4	3.4
Philippines	0.6	-0.1	-0.0	0.9
Latin America	2.1	0.1	1.8	0.4
Sub-Saharan Africa	-0.3	-0.4	-0.1	0.3
Midde East & North Africa	-0.4	-0.8	0.2	0.1
South Asia	0.1	-0.0	0.1	0.0
Developing countries	9.2	-2.3	2.4	8.8
Industrial countries	49.1	9.0	21.5	17.3
World	53.8	6.7	24.0	26.1

Source: Appendix Table 12A.4

* In 1992 US dollars.

Key :

EU = European Union 1994 Members

ANZ = Australia and New Zealand

East Asian NIEs = S. Korea, Taiwan, Hongkong

ASEAN = Indonesia, Malaysia, Singapore, Thailand, Philippines

as in exchange rate targets where bilateral and multilateral current account balances are directly affected. Here countries may already be engaged in strategic game behavior by, for example, pushing for agreements on goals which favor themselves.

Second, information on goals, forecasts, economic structure, and intended actions might be "coordinated" or exchanged. Individual countries can then act on the basis of more accurate information on other countries' future economic magnitudes. This would already be a step toward incorporating externalities, though incompletely.

Third, the choice, magnitude and timing of policy actions might be coordinated. Under this alternative alone, several levels and combinations of commitments are possible.

Discussions of these various aspects above can be held under a strong supranational government much like that envisioned under the European Monetary System, under formal rules and procedures but with each country reserving policy implementation to itself, or under a looser system of periodic talks among the major policy makers where forecasts and intended policy actions are discussed.

The breadth and depth of the discussions also have to be agreed upon and countries will probably consider the exact combination in deciding whether macroeconomic coordination is advantageous to themselves. Breadth or range pertains to what policies will be included in the discussion. A good example of this issue is the present WTO which includes in its areas of coverage such matters as TRIMs (trade-related investment measures), TRIPs (trade-related aspects of intellectual property rights), and agriculture, in addition to trade in commodities traditionally covered by the pre-Uruguay Round GATT. A similar distinction in range of coverage of macroeconomic coordination exists. Wider coverage will afford more areas for trade-offs which may make compromises and agreements easier to achieve. On the other hand, expanding the areas of coverage also bring in more domestic sectors to consult, thereby lessening the flexibility of policy makers in international negotiations.

Depth of negotiations refers to the specificity and disaggregation of policy agreements which can range from broad commitments on macroeconomic balances to commitments on such specific items as tax policy changes. The issue is important because broad agreements on, say, the government deficit will have a variable impact on bilateral current account balances depending on how the deficit or surplus is financed. A similar distinction can be made in structural policies. On the other hand, more specific agreements are harder to achieve and may put *any* agreement out of reach.

Barriers to macroeconomic coordination exist, however. First, international policy bargains that involve shared objectives can be frustrated if some policy instruments are treated as objectives in themselves (*e.g.*, exchange rates). Second, there can at times be sharp disagreements among countries about the effects that policy changes can have on policy targets. Part of the game behavior can be exhibited in trying to get the others to agree to elasticity estimates which favor one country. Third, countries may disagree about the impact of policy instruments on targets. While the differences here can be narrowed by analytical studies, a national agenda may preclude truthful exchange of information. Fourth, there remain huge cross-country differences in the degree of interdependence, leading to differences in willingness to submit to disciplines. Finally, international bargaining comes after domestic bargaining: *i.e.*, compromises between growth and stability at the national level may leave little room for further compromise at the international level.

D. Experience with global economic policy coordination

In some sense the Bretton Woods Agreement in 1944 provided for decentralized national policy-making under certain restrictions —in this case fixed exchange rates needed for expanding world trade. While there have been various criticisms, that arrangement allowed an enormous increase in trade and an unprecedented rate and scope of economic growth throughout the world. This arrangement unravelled when growth in other countries tipped the economic balance toward more equality between the United States (US) on one hand and Japan and Europe on the other, and when the US could no longer bear the numerous country obligations under the Bretton Woods Agreement (i.e., low inflation and disciplined fiscal balance).

The formal rupture in the old arrangement occurred on August 15, 1971 when the US broke the link between the gold and the dollar and other countries consequently had to adjust the values of their currencies. The 10 percent tax that the US imposed on imports was meant to signal how much they felt the other currencies should adjust their exchange rates with respect to the US dollar. On December 17-18, 1991, the Smithsonian Agreement attempted to save the Bretton Woods system by raising the price of gold to $38 per ounce and by expanding the exchange rate bands of the major currencies to 2.25 percent around their new par values (up from one percent under Bretton Woods). However, the system could no longer be salvaged and on February 12, 1973 the US devalued the dollar by 10 percent and all the other major countries allowed their currencies to float against it. This floating rate system has persisted to the present, with all the major currencies (the US dollar, the Deutschmark, the British pound, the Japanese yen and the Swiss franc) without any fixed official exchange rate with each other.

The breakdown of the Bretton Woods exchange rate system turned out to be an important stimulus for international economic policy coordination. With floating exchange rates, governments found they had more control over their macroeconomic policies and proceeded to operate in a manner that was relatively free of the Bretton Woods constraints. However, the enlarged space for discretionary national action led to uncoordinated directions for major economies and markets, resulting in increased external uncertainty. The consequential difficulties provided the impetus for the summit conference in 1975 where inflation and balance of payments issues occupied the ministers' time. Subsequent discussions were carried out under the Group of Five or Seven framework.

Ad hoc coordination of macroeconomic policies was significantly exercised for the first time in 1978 at the Bonn conference where Japan and West Germany agreed to accelerate their growth and the US committed to control its inflation and oil problems. In 1982, the major industrial countries agreed to strengthen multilateral surveillance at the Versailles conference. This was intensified with increasing elements of policy consultation and coordination with the Plaza Accord in 1985 where an orderly appreciation of major non-

dollar currencies against the US dollar was deemed desirable. Governments and central banks of the five major nations declared their willingness to cooperate in order to achieve this objective. The Louvre Accord and December Statement of 1987 confirmed this. A recent example of this cooperation was the 1995 episode when the central banks of major countries (especially the US, Japan and Germany) jointly acted to successfully reverse the appreciation of the yen and the deutschmark against the US dollar.

Günter Grober (1988) concludes that these summit meetings fell short of policy coordination in favor of a limited cooperative approach designed to reduce risk and uncertainty for national policies. Discussion was directed at harmonizing policies and priorities, and judging the functioning of economies and national strategies rather than of policies themselves. "True policy coordination," according to him, "would require participating countries to agree on national measures that are different from those implemented without coordination." In reality and especially where the process is periodic and continuing, this is difficult to distinguish because the discussions will already influence national decisions long before the inconsistencies become glaring.

A more formal version of policy coordination follows the structure proposed for the European Monetary Union under the Maastricht Treaty which became effective in November 1993. In the final stage, envisioned to be implemented by January 1997 (or January 1999 at the latest) are the four convergent criteria governing inflation rates, fiscal deficits, interest rates and the exchange rate. Under this framework, members will be part of an economic and monetary union with the commencement of a European System of Central Banks, the irrevocable fixing of currencies against the European currency unit (ECU), and the rapid introduction of a single currency. Under this system, member countries give up almost all of their independence for macroeconomic policy making in return for the attainment of a single commodity and financial market. The implication is that the expected benefits of a larger market outweigh the loss of benefits from independent macroeconomic policy action.

E. The Economics of Policy Coordination

The gains from economic policy coordination come from several sources. First is the basic increase in welfare from increased commerce—goods and services included—among countries. This is the objective of multilateral trade agreements such as the WTO. By further diminishing the uncertainty in the trade and foreign exchange areas, economic policy coordination adds to the intensity and breadth of commerce among the members. Although it contains other ingredients, the European Common Market is a good example of how a smaller grouping can enhance trade even beyond global multilateral systems (in this case GATT).

Another source of gain from policy coordination is reduced uncertainty as countries exchange more information about their economic situation, structure and policies. A third source also comes from reduced uncertainty when countries unmistakably convey their intentions in economic discussions. A fourth very important source is reduced adjustment costs and increased policy benefits as countries simultaneously incorporate the policy actions and responses of other members during their first cut in policy design. This may be resorted to in lieu of ratchety adjustments as other countries adjust and readjust to each other's policies (assuming that there is policy convergence).

The final source of gain is the increased ability of countries to undertake difficult policy changes that they would otherwise have been unable to implement. There is a presumption, supported by the experience of multi-country groupings such as the European Community, that these policy coordination exercises typically require policies which are in some fundamental sense good for the countries. As economic policy coordination exercises become more intense and more frequent, the discipline needed is achieved.

At the same time, there are costs to economic policy coordination. The most obvious is the loss of strategic behavior in relation to other countries, e.g., exchange rate targeting. As more information becomes available and policy reviews become more frequent, the ability to undertake this behavior is drastically reduced. The second source of costs, both political and economic, comes from a country's reduced ability to design and time policy responses to

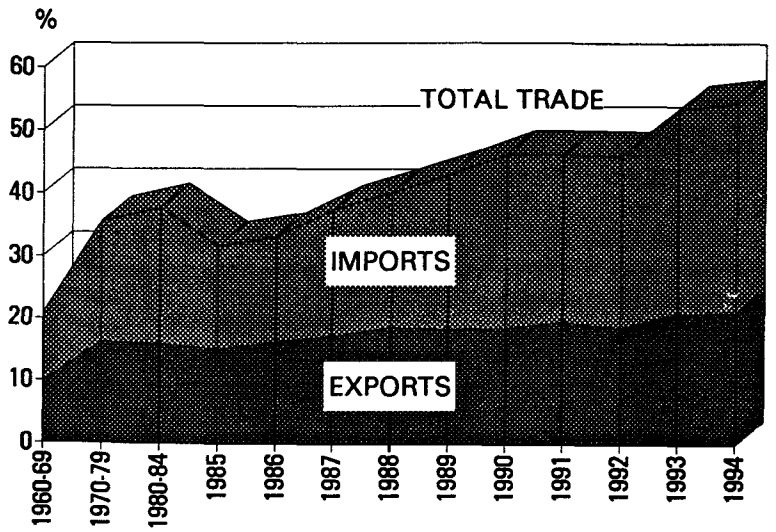
external (and internal) events. The combination of both developments leads to a reduced ability to design policies finely honed to a country's circumstances. The trade-off is of course improved circumstances afforded by the positive externalities of economic policy coordination.

III. MACROECONOMIC COORDINATION FOR THE PHILIPPINES

A. The Philippine situation

The Philippines also shows the general trend of increasing openness. Figure 12.1(c) (see p. 347, above) shows how total trade has increased as a proportion of gross domestic product for the Philippines and other ASEAN countries.[2] For the Philippines, the pattern shows an increasing percentage since 1986, a recovery since the lowest point in 1984-85. This can been seen in Figure 12.5.

Figure 12.5. Ratio of exports, imports, and total trade to GDP, in the Philippines (in percent)

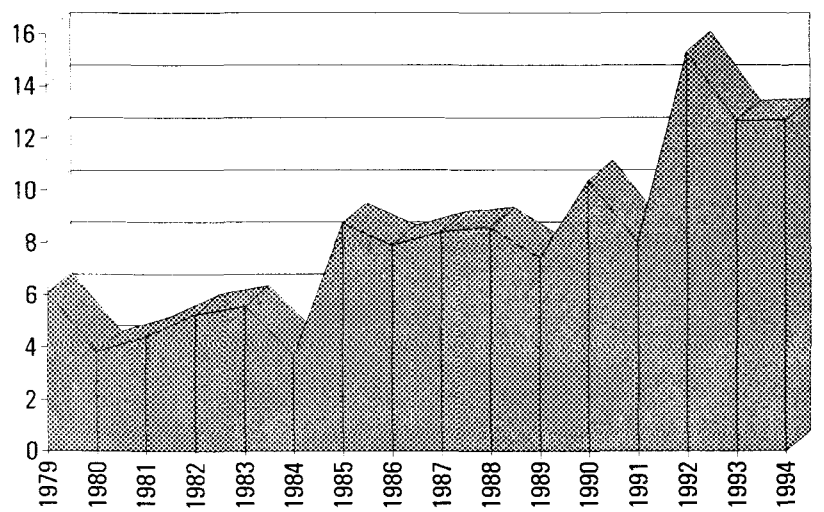


Source: Appendix Table 12A.6

Figures 12.2 (see p. 348, above) and 12.4 (see p. 349, above) also show how capital flows to developing countries have increased and how the equity market capitalization has increased tremendously in the Philippines in the last few years.[3] The gross capital flow ratios and foreign investment inflows for the Philippines suggest the increasing openness of capital accounts over the past one and a half decades, particularly in the 90s (see Figures 12.6 and 12.7, below).

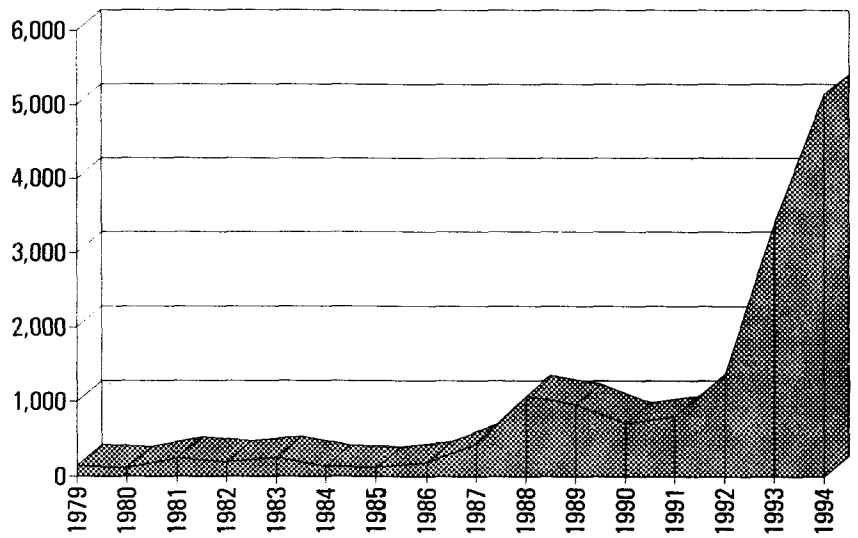
An interesting issue is the increasing interaction among ASEAN members with the implementation of the ASEAN Free Trade Agreement (AFTA) and the possibility of deepening the Asia Pacific Economic Cooperation (APEC). Increased trade among the ASEAN members is expected to deepen the interdependence among these

Figure 12.6. Ratio of gross capital flows to GDP, in the Philippines, 1979-1994 (in percent)



Source: Appendix Table 12A.7

Figure 12.7. Foreign investment inflows to the Philippines, 1979-1994 (in US$ million)



Source: Appendix Table 12A.7

countries. Simulation results by Tuh Mun Heng and Linda Low (1990), for example, show there will be a decrease in domestic income multipliers and an increase in cross-country multipliers with increasing intra-ASEAN trade. Table 12.5 shows the change in multipliers with a 50 percent increase in ASEAN trade. That is, interdependence increases with increasing trade openness. They conclude further that "better coordination of trade policies and national policies ... become even more important" under these circumstances. Joseph F. Yap and Aleli dela Paz (1990) also showed that "while the effects of external shocks on domestic economies could be reasonably estimated in isolation, there is some worth in testing the effects using a linked model."[4] An integrated outlook may therefore be useful for national policy making.

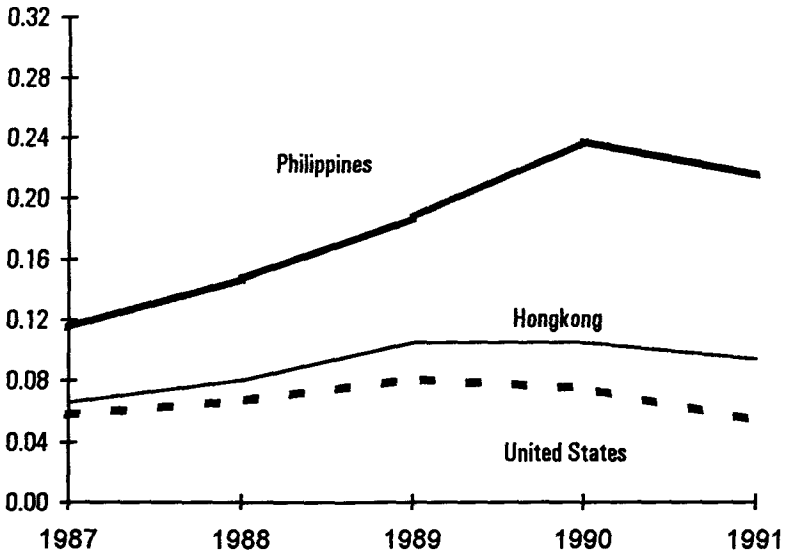
Table 12.5. Simulation results of a 50 percent increase in ASEAN trade

		G1	G2	G3	G4	G5
(a) Period 2						
Indonesia	Y1	2.4150	0.0963	0.0508	0.3554	0.0319
Malaysia	Y2	0.0295	1.5485	0.0374	0.2904	0.0571
Philippines	Y3	0.0105	0.0408	3.0867	0.0450	0.0109
Singapore	Y4	0.1078	0.2967	0.0341	1.2480	0.0786
Thailand	Y5	0.0200	0.0835	0.0117	0.1117	2.5057
(b) 50% increase in ASEAN trade						
Indonesia	Y1	2.3331	0.1573	0.0766	0.4509	0.0555
Malaysia	Y2	0.0479	1.4100	0.0525	0.3399	0.0809
Philippines	Y3	0.0169	0.0579	2.9978	0.0610	0.0173
Singapore	Y4	0.1368	0.3472	0.0474	1.1014	0.1031
Thailand	Y5	0.0325	0.1184	0.0190	0.1471	2.4077
(b)-(a) Differential						
Indonesia	Y1	-0.0819	0.0610	0.0259	0.0955	0.0236
Malaysia	Y2	0.0184	-0.1385	0.0151	0.0495	0.0239
Philippines	Y3	0.0064	0.0171	-0.0889	0.0160	0.0064
Singapore	Y4	0.0291	0.0504	0.0133	-0.1466	0.0245
Thailand	Y5	0.0125	0.0350	0.0073	0.0354	-0.0980

Source: Yap and dela Paz (1990)

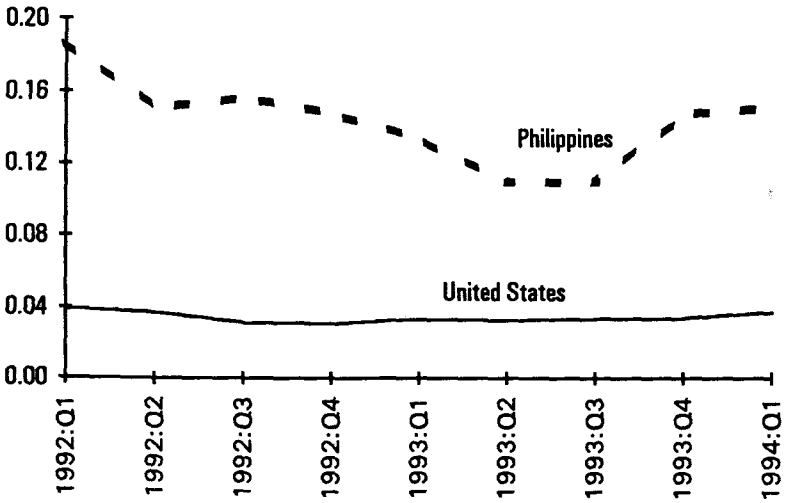
This increasing interaction raises the possibility that the Philippine economy is now substantially integrated with global financial markets. In the last few years, policy reforms have made it increasingly so (Paderanga, 1996). Sakai (1994), for example, asserts that Philippine interest rates are more correlated with New York and Hongkong interest rates than with domestic supply and demand conditions. Figures 12.8 and 12.9 illustrate Sakai's

Figure 12.8. Interest rates in the United States, Hongkong and the Philippines, 1987-1991



Source: Appendix Table 12A.8

Figure 12.9. Quarterly interest rates in the United States and the Philippines, 1992:Q1-1994:Q1



Source: Appendix Table 12A.9

hypothesis. A rough and preliminary test using the uncovered interest rate parity condition (Paderanga and Tan, 1996) indicates that the Philippines is financially integrated with the rest of the world. At any rate, the current trends in the economy point toward increasing openness and integration within the next few years to a degree that economic vulnerability and the need for economic policy coordination have become serious issues.

B. Policy coordination for the Philippines?

The Philippine economy is now more integrated in trade and financial terms with the rest of the world and will rapidly become more so in the medium term. This is especially true of our relationships within ASEAN. It will also be true within APEC when cooperation there accelerates as recent trends seem to indicate. The question before a small, open economy like the Philippines is whether to commit to economic policy coordination, how deeply, and under what arrangements.

The gains from economic policy coordination, including more agreements in trade and investments, will come from increased access to a larger market. Under AFTA, the emergence of an ASEAN market is no longer in doubt. Our task is to adjust to the new conditions. APEC offers increased access just by the mere exchange of information and easier connections even under its most modest agenda. In both cases, the Philippine strategy to develop under open markets will be tremendously facilitated. Table 12.6 shows the surge in intra-Pacific trade during the 1980s. This has continued unabated up to the present.

Increased confidence in our ability to weather crises is also enhanced by: (1) increased and early exchange of information on economic and political developments; (2) complementary agreements regarding assistance during crises (for example, temporary liquidity arrangements to respond to adverse capital flows); and (3) specific cooperative agreements which may be expected to follow. These have the immediate effect of reducing country risk and therefore decreasing the cost of capital and of doing business. Increased access to resources resulting from this can accelerate development.

Table 12.6. Intra-Pacific trade, 1980 and 1990

		1980	1990
1.	Intra-Pacific trade (billion US $)	378.0	939.3
2.	Intra-North American trade		
	Dollar value (billions)	102.0	230.0
	Share of (1), percent	27.0	24.5
3.	Intra-East Asian trade		
	Dollar value (billions)	100.7	286.3
	Share of (1), percent	27.0	30.5
4.	North American and East Asian trade		
	Dollar value (billions)	118.6	326.0
	Share of (1), percent	31.4	34.7

Source: Dobson (1993)

C. Costs of policy coordination

The costs of policy coordination consist primarily of the loss of independence and ability to maneuver. First, there are fewer policy instruments available. For example, in that environment the ability to target the exchange rate or use the exchange rate to target levels of current account balance is severely curtailed. Room for strategic behavior becomes extremely limited. The predatory export programs and competitive exchange rates used by Japan and the newly industrializing countries (NICs) in the past are no longer available.[5] Second, there may also be restrictions on the depth and timing of policy instruments which are still available. For one, policy changes with a significant impact on other members will need to be discussed

before being used. A bureaucratic and complicated process in the adoption of policy instruments may make decision making unwieldy and inflexible, resulting in opportunity losses. Finally, because of the limitations on policy instruments, some development strategies which rely on programs that exploit strategic behavior may no longer be available.

IV. RECOMMENDATIONS

The Philippines needs to recognize that there are costs and benefits to economic policy coordination and to act on that basis. In the end, it will have to decide whether it is a net gain or loss to commit to economic policy coordination. The following recommendations fall into two parts. The first consists of suggestions for a research program to (1) add up the costs and benefits of joining an economic policy coordination agreement; and (2) identify the areas where policy coordination will have an adverse impact and the measures to insulate these areas. The second part consists of suggestions for the government to formulate a strategic agenda for the discussions on policy coordination.

The research program needs to identify the areas of the economy which would have benefited from an environment without policy coordination (e.g., one where strategic behavior would have been advantageous for us) and analyze how the new environment will affect these areas. The costs of inflexibility in decision making and the loss of some instruments may not be easily computed but these nonetheless have to be recognized. These costs will be weighted against the benefits of committing to policy coordination (some of which can be estimated, such as the benefits from increased trade).

The government can then formulate a strategic agenda for approaching the economic policy coordination discussions. Several components can be identified this early. First, we can negotiate to exclude certain areas where we expect some losses. Second, we can negotiate for temporary differential treatment for countries under certain conditions. Third, we can also propose a system where inter-country assistance is available in case of adverse externalities due to policy coordination. Finally, we can formulate the rules which we feel are optimal for the Philippines and push for their acceptance.

In the case of economic policy coordination, the correct answer may not be a categorical yes or no. Rather, it may be how we shape the rules and the mechanisms to address the opportunities and problems presented by the changing environment. The challenge for the Philippines is how to alter its policy, decision making and negotiating mechanisms to take full advantage of the opportunities provided by increased economic cooperation and whatever coordination may be collectively agreed upon.

NOTES

[1]The importance of this phenomenon may be inferred from the gravity models being applied to international trade. See for example, Frankel *et al.* (1995).

[2]The absolute values for Thailand and Indonesia are larger but because their economies are bigger, the percentages are clustered closer.

[3]Although their results show decreases (compared to the base runs) in some macroeconomic variables with increases in intra-ASEAN trade.

[4] Montiel's (1994) results using the uncovered interest parity test indicate otherwise. However, his test covered an earlier period than ours.

[5]Former Taiwanese Minister for Economic Affairs K.T. Li once asserted in a private conversation that they did not have an exchange rate policy *per se*. But after they realigned the New Taiwan Dollar in the late 1950s, they had a policy of low inflation (which effectively achieved real exchange rate depreciation under fixed nominal exchange rates).

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APPENDIX

Some International Coordination Agreements

1971 Smithsonian Conference on exchange rates.

1975 "First" economic conference, when inflation and balance of payment (BOP) disequilibria had upset the world economy. (Subsequent annual meetings of heads of seven major industrial countries followed using the Group of Five or Seven format).

1978 Bonn Economic Summit: Japan and the Federal Republic of Germany agree to accelerate growth while the United States agreed to control its inflation and oil problems. (*Ad hoc* coordination of macroeconomic policies begin).

1982 Versailles Economic Summit: Called for the strengthening of multilateral surveillance.

1985 Plaza Accord: Elements of policy coordination appeared.

1986 Tokyo Economic Summit: closer and more frequent consultations in between annual meetings.

1987 Louvre Accord: Elements of policy coordination reinforced, February. Statement of the Group of Seven in December also restated this.

Note: Excluded from this list are the near continuous discussion and decision making at the executive boards of the International Monetary Fund and the World Bank.

Table 12A.1. Selected indicators of economic integration/openness in ASEAN countries, 1980-1994 (in percent)

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994
PHILIPPINES															
GCF*/GDP									1.84	1.62	2.44	3.26	3.24	4.97	
X*/GDP	17.84	16.05	13.52	15.07	17.16	15.06	16.21	17.17	18.59	18.38	18.52	19.52	18.54	20.92	21.03
M*/GDP	23.81	22.29	20.64	22.54	19.33	16.63	16.89	20.23	21.45	24.48	27.62	26.61	27.41	32.37	33.27
X+M*/GDP	41.65	38.34	34.16	37.61	36.49	31.69	33.10	37.40	40.04	42.85	46.14	46.13	45.95	53.29	54.30
MALAYSIA															
GCF*/GDP									4.92	2.73	3.36	5.96	9.48	11.12	6.05
X*/GDP	52.55	46.69	44.64	45.09	48.34	48.50	48.85	56.18	60.10	67.38	67.62	28.59	68.64	72.98	80.57
M*/GDP	42.72	47.45	47.45	43.67	39.55	37.04	37.14	37.72	44.11	56.69	61.37	34.66	63.21	68.21	78.34
X+M*/GDP	95.27	92.02	92.09	88.75	87.89	85.54	85.99	93.90	104.21	124.07	128.99	63.25	131.85	141.19	158.91
THAILAND															
GCF*/GDP									3.15	5.07	5.71	6.21	4.63	7.25	6.03
X*/GDP	20.05	19.81	19.17	15.94	17.82	18.95	21.20	23.83	25.72	27.60	26.64	28.59	28.78	29.07	31.06
M*/GDP	25.96	25.64	21.22	23.17	22.43	22.44	20.21	24.56	28.86	31.47	34.52	34.66	32.51	32.46	33.65
X+M*/GDP	46.01	45.45	40.39	39.12	40.25	41.39	41.41	48.39	54.58	59.06	61.16	63.25	61.29	61.53	64.71
INDONESIA															
GCF*/GDP									1.43	1.66	2.21	2.45	2.46	1.83	1.10
X*/GDP	30.07	27.30	21.90	21.88	23.69	21.21	17.98	22.66	23.14	23.38	25.26	25.41	26.40	23.17	23.03
M*/GDP	17.42	19.34	19.80	20.75	17.17	14.55	14.91	16.50	16.41	16.60	20.21	21.29	20.91	17.96	18.51
X+M*/GDP	47.49	46.65	41.70	42.63	40.86	35.76	32.89	39.16	39.55	39.97	45.47	46.71	47.31	41.13	41.54
SINGAPORE															
GCF*/GDP									14.05	31.19	16.15	11.71	14.88	11.45	14.84

Sources of basic data: IMF (1995) International Financial Statistics; ADB Key Indicators, NCSB, BSP

Notes: GCF is Gross capital formation; X is Exports; M is Imports; X+M is Total Trade.

Table 12A.2. Selected capital flows to developing countries (in US$ billion)

	1960s	1970s	1980s	1991	1992	1993
Net FDI	0.30	3.02	12.99	34.48	44.87	63.99
FPI	0.01	0.42	3.35	17.51	24.25	86.57
Net KB lending	0.38	9.84	11.79	1.89	14.54	5.48
Official debts and Grants	1.47	9.85	34.37	59.30	47.38	52.34

Source: Bergsman and Shen (1995)
Note: Figures for the 1960s, 1970s and 1980s represent annual averages for those decades.
Key: FDI = foreign direct investment
FPI = foreign portfolio investment
KB = commercial bank

Table 12A.3. Equity market capitalization as percent of GDP in selected ASEAN countries, 1989-1994

	1989	1990	1991	1992	1993	1994
INDONESIA	2.4	7.6	5.8	9.4	22.8	30.2
PHILIPPINES	28.1	13.4	22.5	26.0	74.1	86.9
THAILAND	35.5	27.9	36.3	52.0	104.5	94.0
MALAYSIA	105.0	113.6	124.4	162.1	342.1	282.7
SINGAPORE	123.4	94.0	112.5	100.6	240.4	216.9

Source: World Bank (1995) World Debt Tables

Table 12A.4. Welfare effects of the Uruguay Round (in US$ billion*, percent)

	(1) Agricultural Reform		(2) Multi-fiber Agreement (MFA) Reform		(3) Manufacturing Sector Reform		(4) Uruguay Round		(5) Complete Reform as a percentage of GDP	
	Short-term	Long-term	Short-term	Long-term	Short-term	Long-term	Short-term	Long-term	Short-term	Long-term
Australia	0.7	0.9	0.0	0.1	0.5	2.3	1.2	3.3	0.4	1.1
New Zealand	0.3	0.5	0.0	0.0	0.1	0.9	0.4	1.4	1.0	3.6
Canada	0.3	0.2	0.9	1.0	0.1	1.3	1.3	2.6	0.2	0.5
United States	1.8	3.2	10.0	9.2	1.2	13.7	13.3	26.7	0.2	0.5
Japan	15.1	16.8	-0.6	-0.5	2.2	6.2	16.9	22.7	0.5	0.6
South Korea	4.6	5.2	-0.5	-0.4	0.7	2.7	4.8	0.5	1.5	2.5
European Union**	28.3	26.4	7.6	7.8	3.0	14.9	39.3	0.9	0.6	0.7
Indonesia	0.2	0.3	0.6	0.9	0.6	1.4	1.3	2.6	1.1	2.1
Malaysia	1.2	2.2	0.1	0.3	0.7	2.6	1.8	5.0	3.3	8.8
Philippines	0.7	1.1	0.0	0.2	0.4	1.1	0.9	2.4	1.6	4.4
Singapore	0.6	0.5	-0.2	-0.2	0.5	0.4	0.9	0.7	2.1	1.7
Thailand	0.8	1.4	0.1	0.8	1.8	10.3	2.5	12.6	2.1	10.9
China	-0.5	-0.8	1.0	1.7	0.9	1.2	1.3	2.0	0.3	0.5
Hongkong	1.5	0.6	-1.7	-1.5	-0.1	-0.2	-1.2	-1.1	-1.4	-1.1
Taiwan	-0.2	0.0	-0.4	-0.3	0.8	1.3	0.4	1.1	0.2	0.5

(continued next page)

Table 12A.4. (continued)

	(1) Agricultural Reform		(2) Multi-fiber Agreement (MFA) Reform		(3) Manufacturing Sector Reform		(4) Uruguay Round		(5) Complete Reform as a percentage of GDP	
	Short-term	Long-term	Short-term	Long-term	Short-term	Long-term	Short-term	Long-term	Short-term	Long-term
Argentina	0.4	0.7	0.0	0.1	0.3	1.6	0.7	2.3	0.3	1.0
Brazil	0.3	0.1	-0.0	0.1	1.2	4.0	1.4	4.3	0.3	1.1
Mexico	-0.0	0.7	-0.1	0.2	0.3	1.4	0.2	2.3	0.0	0.7
Latin America	1.5	2.0	-0.5	0.3	0.3	3.2	1.3	4.7	0.4	1.7
Sub-Saharan Africa	-0.2	-0.5	-0.0	-0.1	0.1	0.2	-0.3	-0.7	-0.2	-0.4
Midde East & North Africa	-0.3	0.1	-0.4	0.2	0.8	1.9	-0.3	1.5	-0.1	0.3
Eastern Europe***	-0.1	-0.0	-0.5	-0.3	0.8	2.3	-0.2	1.2	-0.1	0.1
South Asia	0.3	0.2	0.9	1.9	3.1	5.3	3.7	6.7	1.0	2.0
Europe (others)	2.2	1.6	-0.2	-0.8	1.7	7.0	4.2	8.8	0.3	0.7
Developing countries	9.9	13.9	-1.5	3.4	12.9	40.5	19.4	55.2	0.4	1.2
Industrial countries	48.7	49.8	17.9	16.9	8.7	46.3	76.7	115.4	0.4	0.6
World	58.6	63.7	16.4	20.3	21.7	86.8	96.0	170.6	0.4	0.7

Source: Harrison, Rutherford and Tarr (1995)

Note: The first three headings represent the effect of each reform by itself.
The fourth heading (Uruguay Round) reports the effects of all reforms combined.

* In 1992 US dollars.
** Membership in 1994
*** Also includes the Baltic countries, Russia, and other countries of the former Soviet Union.

Table 12A.5. Decomposing the welfare effects of agricultural reform (in US$ billion)

	All distortions*	Export Subsidies	Production Subsidies	Import Distortions
Australia	0.7	0.1	0.1	0.4
New Zealand	0.3	0.1	0.1	0.1
Canada	0.2	0.0	0.3	-0.1
United States	1.7	-0.0	1.5	-0.1
Japan	15.2	-2.2	-0.5	17.7
South Korea	4.6	-0.2	-0.0	4.7
European Union**	28.5	11.5	17.8	-1.2
Indonesia	0.2	0.0	0.1	0.1
Malaysia	1.2	0.0	0.1	1.2
Philippines	0.6	-0.1	-0.0	0.9
Singapore	0.6	-0.0	0.0	0.6
Thailand	0.7	-0.0	0.2	0.6
China	-0.6	-0.2	-0.1	-0.3
Hongkong	0.6	0.1	0.0	0.2
Taiwan	0.0	-0.0	0.0	0.1
Argentina	0.4	0.1	0.2	0.1
Brazil	0.3	-0.0	0.2	0.1
Mexico	-0.0	-0.0	-0.0	0.1
Latin America	1.4	-0.0	1.4	0.1
Sub-Saharan Africa	-0.3	-0.4	-0.1	0.3
Midde East & North Africa	-0.4	-0.8	0.2	0.1
Eastern Europe***	-0.2	-0.6	0.3	0.0
South Asia	0.1	-0.0	0.1	0.0
Europe (others)	2.4	-0.6	2.1	0.5
Developing countries	9.2	-2.3	2.4	8.8
Industrial countries	49.1	9.0	21.5	17.3
World	53.8	6.7	24	26.1

Source: Harrison, Rutherford and Tarr (1995)

* Import distortions and export and production subsidies on agricultural products.

** Membership in 1994

*** Also includes the Baltic countries, Russia, and other countries of the former Soviet Union.

Table 12A.6. Philippine external trade as percentage of gross domestic product, 1960-1994

	Exports	Imports	Trade
1960-69	9.84	10.98	20.82
1970-79	16.21	19.42	35.63
1980-84	15.93	21.72	37.65
1985	15.06	16.63	31.69
1986	16.21	16.89	33.10
1987	17.17	20.23	37.40
1988	18.59	21.45	40.04
1989	18.38	24.48	42.86
1990	18.52	27.62	46.14
1991	19.52	26.61	46.13
1992	18.54	27.41	45.95
1993	20.92	32.37	53.29
1994	21.03	33.27	54.30

Source of basic data: BSP, NSCB
Note: Trade = exports + imports

Table 12A.7. Foreign direct investment (FDI) inflows and GCF/GDP ratio, Philippines, 1979-1994 (in US$ millions, %)

	FDI	GCF/GDP
1979	146	6.07
1980	119	3.80
1981	248	4.39
1982	194	5.24
1983	255	5.54
1984	137	3.66
1985	124	8.73
1986	186	7.88
1987	439	8.39
1988	1,077	8.56
1989	961	7.39
1990	706	10.37
1991	798	8.00
1992	1,364	15.29
1993	3,394	12.67
1994	5,142	12.70

Source of basic data: BSP, NSCB

Note: GCF is gross capital flows = inflows plus outflows of FDI plus one-half of total medium- and long-term loans (MLT/2).

Table 12A.8. Interest rates in the US, Hongkong and the Philippines, 1987-1991 (in percent)

	United States	Hongkong	Philippines
1987	5.8	6.6	11.5
1988	6.7	8.0	14.7
1989	8.1	10.5	18.7
1990	7.5	10.5	23.7
1991	5.4	9.4	21.5

Source: Sakai (1995)

Table 12A.9. Quarterly interest rates in the US and the Philippines, 1992:Q1 - 1994:Q1 (in percent)

	United States	Philippines
1992:Q1	3.91	18.63
1992:Q2	3.72	15.01
1992:Q3	3.13	15.61
1992:Q4	3.08	14.76
1993:Q1	3.31	13.33
1993:Q2	3.26	10.87
1993:Q3	3.33	10.90
1993:Q4	3.38	14.70
1994:Q1	3.71	15.09

Source: Sakai (1995)

COMMENTS

*Ma. Lourdes A. Sereno**

I think the debate has already gone beyond the question of whether or not we need macroeconomic coordination. It is beyond us to reverse the trend of economic interdependence. I think the major concern should instead be: How do we try to take control of the power processes in macroeconomic coordination? That is really where all the muscling and the arm twisting comes into play.

The second point is related to the concern for a measure of credibility of government policies here in the Philippines, given the political limitations of the government, particularly the lack of policy coordination, the lack of political will. Some of the sectors concerned do not respond to the policies the way they are expected to.

Dr. Cayetano Paderanga's paper really stresses the need for strategic planning, although he was saying that there is less room for strategic behavior outside of coordination. In fact, there is still room for strategic behavior within the area of macro coordination. In the ASEAN, APEC, and the WTO, there will be an increasing demand for policy coordination. And even the WTO member countries, especially developing ones like the Philippines, have been granted some leeway for independent action. Our task is to try to understand how this process will work in the future and to position ourselves to take advantage of that process.

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* Associate Professor, College of Law, University of the Philippines in Diliman and Director, Institute of International Legal Studies

COMMENTS

*Ponciano Intal, Jr.**

Why worry about coordination at the regional level? I would like a kind of framework which can show that we need to have greater coordination for the benefit of the country. But this means looking at the link between macroeconomic variables and Philippine economy, and not just the link between the former and international and financial markets. The paper of Dr. Cayetano Paderanga, Jr. suggests that our macroeconomic policy is ineffectual or that there is little coordination among the macroeconomic policy officials. So it might be useful for the paper to first show why, from a national perspective, increased macroeconomic coordination at the regional level will be beneficial to us.

Second, the history of macroeconomic coordination in the European Community has been dismal. If it did not work in Europe, why would macroeconomic coordination work in the Asia Pacific region?

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* President, Philippine Institute for Development Studies.

13. Legal Rights and Obligations in International Trade Law: Focus on the WTO Agreement

Maria Lourdes A. Sereno

INTRODUCTION

The purpose of this paper is to inquire into the role of international law and the specific role of international economic law in Philippine law, and to present the highlights of rights and obligations embodied in the Agreement Establishing the World Trade Organization (WTO) Treaty.

I. INTERNATIONAL LAW IN PHILIPPINE LAW

The President has the power to enter into treaties, but for such treaties to have the status of Philippine law it is additionally provided that: "No treaty or international agreement shall be valid and effective unless concurred in by at least two-thirds of all the Members of the Senate" (Section 21, Article VII, 1987, Philippine Constitution).

Treaties with the status of law in our country can be classified according to whether they are self-executing, or they need further implementing legislation such as multilateral treaties or conventions which provide for general principles or standards of state behavior. The nature of treaties or conventions which the Philippines have entered into do not, by themselves, provide independent causes of action in Philippine law unlike, for example, provisions on the European Convention on Human Rights by which an individual can be the subject of an international convention, or treaties under which an individual can immediately sue either the state or another individual.

Invariably, our Supreme Court, the constitutionally constituted body with the power to interpret laws, has pronounced international treaties as having the same status as statutes emanating from Congress. In the case of *Singh v. Collector of*

Customs (38 Phil 867), the Supreme Court pronounced that "a treaty is placed upon the same footing and made of like obligation with the Act of Congress" and that "no superior efficacy is given to either over the other." A similar pronouncement was made by the Supreme Court in the case of *Abbas v. COMELEC* (179 SCRA 287) about the equal treatment of the Congressional Act creating the Autonomous Region of Muslim Mindanao and the Tripoli Agreement. In the legal hierarchy, therefore, international treaties occupy a rung just one step lower than the constitution.

In case of conflict between municipal law and a treaty, there are two theories on the matter.

The first is that the more recent law prevails under the principle of implicit repeal, as was held in the case of *Singh v. Collector of Customs.* The Supreme Court declared that: "If the treaty and the Congress are inconsistent, the one last in date will control," thus upholding the Act of Congress which was enacted more recently, which Act prohibited certain persons from India from entering the Philippines (an American colony) despite the existence of a prior Treaty between the United States and Great Britain. In the case of *Ichiong v. Hernandez* (G.R. No. L-7995, May 31, 1957), the Retail Trade Nationalization Law was challenged on the ground, among others, that it violated the Treaty of Amity between the Philippines and China, the United Nations Charter and the Universal Declaration of Human Rights. After rejecting the assertion, the Supreme Court made the following remark:

> *But even assuming that the law infringes upon the said treaty, the treaty is always subject to qualification or amendment by a subsequent law, and the same may never curtail or restrict the scope of the police power of the state.*

In the more recent case of *Abbas v. COMELEC* (179 SCRA 287, 294), the Supreme Court, in upholding the validity of Republic Act (RA) No. 6734 creating the Autonomous Region of Muslim Mindanao despite the existence of the Tripoli Agreement, pronounced:

> *We find it neither necessary nor determinative of the case to rule on the nature of the Tripoli Agreement and its binding effect on the Philippine Government whether under public international or internal Philippine law. In the first place, it is now the Constitution itself that provides for the creation of an autonomous region in Muslim Mindanao... [A]ssuming for the sake of argument that the Tripoli Agreement is a binding treaty or international agreement, it would then constitute part of the law of the land. But as internal law, it would not be superior to R.A. 6734, an enactment of the Congress of the Philippines, rather it would be in the same class as the latter... Thus, if at all, R.A. No. 6734 would be amendatory of the Tripoli Agreement, being a subsequent law. Only a determination by this Court that R.A. 6734 contravenes the Constitution would result in the granting of the relief sought.*

The second theory, which is applied in cases where there arises a conflict between municipal law and a treaty, states that in the absence of an express provision of an international treaty, municipal law prevails (Salonga citing Mortensen v. Peters).

II. INTERNATIONAL ECONOMIC LAW

It is important to understand whether international economic law has sufficient efficacy in this jurisdiction for the term "law" to apply as an independent source of obligation defined by the Civil Code, the legal foundation for any cause of action. The former Director-General of the General Agreement on Tariffs and Trade (GATT) has expressed a strong view espousing self-interest as a reason for giving domestic effect to international economic law, thus:

> *International economic policy commitments, in the form of agreed rules, have far-reaching domestic effects, indeed effects so important that they are indispensable for democratic governance. They are the element which secures the ultimate coordination and mutual compatibility of purely domestic economic*

> *policies. They form the basis from which the government can arbitrate and secure an equitable and efficient* ***balance between the diverse domestic interests: producers vs. consumers, export industries vs. import-competing industries, between particular*** *narrowly-defined industries. Last but not least, only a firm commitment to international rules makes the all-important reconciliation, which I have already alluded to, of the necessary balance on the production side and on the financial side of the economy.*
>
> *I am still convinced that it is in the national interest of every trading nation to abide by the rules, which were accepted as valid for good times and bad, and to frame their internal policies accordingly. One of the major benefits of international disciplines is that they offer equal opportunities and require comparable sacrifices from all the countries involved in international competition. Those who believe in the open trading system must recognize and accept the need to correct those rigidities in their economic and social systems which obstruct the process of continuing adjustment on which economic growth depends.* (in Jackson 253)

The question of the effectiveness of international law is not new and there is no particular reason why international economic law, and even GATT rules, present an exception. In confronting the dilemma of the enforceability or effectiveness of international trade rules, Professor Jackson presents to us an array of approaches that have been used:

> *Thus it can be seen that a variety of techniques have been utilized in GATT to achieve some of the basic objectives of the international community with respect to international trade and commerce. The four mentioned above can be summarized as: (1) legal norms, backed by a complaint or a dispute-settling procedure; (2) elaborate discussion and consultation, with a view to alerting other nations to future national policies; (3) the use of Working Parties, subcommittees,*

and discussions in plenary sessions to bring moral force upon countries to conform their individual national policies and practices to either the legal norm or the stated objectives of GATT; and (4) the use of negotiation and bargaining as a means to formulate new obligations and to settle differences about old obligations.

Despite attempts to bring about greater observance of international trade rules, the lamentable fact remains that no adequate enforcement of decisions by Working Panels constituted under GATT has been made. It was in this spirit that stringent conditions and obligations for and on membership in the WTO have been stipulated in the form of: (1) the "all or nothing" approach in the WTO Treaty proper, and (2) the quasi-automatic adoption clause in the understanding on Dispute Settlement Agreement.

Under the WTO Treaty proper, Article II states:

1. *The WTO shall provide the common institutional framework for the conduct of trade relations among its Members in matters related to the agreements and associated legal instruments included in the Annexes to this Agreement.*

2. *The agreements and associated legal instruments included in Annexes 1, 2 and 3 (hereinafter referred to as "Multilateral Trade Agreements") are integral parts of this Agreement, binding on all Members.*

Article XVI includes the following provisions:

4. *Each Member shall ensure the conformity of its laws, regulations and administrative procedures with its obligations as provided in the annexed Agreements.*

5. *No reservations may be made in respect of any provision of this Agreement. Reservations in respect of any of the provisions of the Multilateral Trade Agreements may only be made to the extent provided for in those Agreements. Reservations in respect of a provision of a Plurilateral Trade Agreement shall be governed by the provisions of that Agreement.*

These provisions clearly indicate that internal difficulties and exceptions to compliance by prior reservations are not acceptable. A degree of uniformity and the legal compulsion for compliance with the "rules" and "disciplines" imposed by the WTO treaty, is imposed.

The "teeth" of the rules and disciplines lie in the radicalized approach to the adoption and enforcement of decisions taken by the "Understanding on Rules and Procedures Governing the Settlement of Disputes."

In the counterpart provisions under the old regime, panel reports were not adopted without the consensus of the Contracting Parties to the 1947 GATT. This created many situations of "stalemate," where one of the disputants would simply use its political muscle to block the adoption of a panel and thus defeat the legal rights of the other disputant. Under the new rules, there are "quasi-automatic adoption clauses" which provide for the automatic adoption of a panel report or a decision of the Appellate Body unless it is rejected by consensus of the Dispute Settlement Body (DSB). The Dispute Settlement Body is composed of the entire membership of the WTO. The provisions of the "Understanding" reads:

Article 16

Adoption of Panel Report

4. *Within 60 days after the date of circulation of a panel report to the Members, the report shall be adopted at a DSB meeting unless a party to the dispute formally notifies the DSB of its decision*

to appeal or the DSB by consensus decides not to adopt the report. If a party has notified its decision to appeal, the report by the panel shall not be considered for adoption by the DSB until after completion of the appeal. This adoption is without prejudice to the right of Members to express their views on a panel report.

Article 17

Appellate Review

6. *An appeal shall be limited to issues of law covered in the panel report and legal interpretations developed by the panel.*

...

14. *An Appellate Body report shall be adopted by the DSB and unconditionally accepted by the parties to the dispute unless the DSB decides by consensus not to adopt the Appellate Body report within 30 days following its circulation to the Members. This adoption procedure is without prejudice to the right of Members to express their views on an Appellate Body report.*

Whereas in the past a great deal of political muscling had to be accomplished before a panel report was adopted, the opposite is now true: the burden of moving for a rejection of either a panel report or an Appellate Body report falls on parties who wish to block the operation of the "automatic adoption" clauses.

The Agreement establishing the WTO was "accepted" by the Philippines by virtue of Philippine Senate Resolution No. 1083 on December 14, 1994. The WTO Treaty came into force on January 1, 1995.

III. THE URUGUAY ROUND OF MULTILATERAL TRADE NEGOTIATIONS

The 1994 Uruguay Round of Multilateral Trade Negotiations resulted in a 550-page document embodying new legal provisions on the conduct of international trade. The document is supplemented by a Schedule of Commitments and Concessions (on trade in goods) and a Schedule of Specific Commitments (on trade in services) of each member/participant country. Many of the provisions in the different agreements, which are not specific commitments, are modifications or supplements to the 1947 General Agreement on Tariffs and Trade.

The 1994 GATT consists of the 1947 GATT, the Protocol of Provisional Application (under which it came into force), and the interpretations, modifications, and basic agreements and understanding on the 1947 GATT. Some of the Agreements in the 1994 GATT such as the General Agreement on Trade in Services (GATS), the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS), and the Agreements on Agriculture and on Textiles and Clothing are completely new in the sense that the nature of legal obligations they contain have for the first time been included within the full ambit of GATT.

The Uruguay Round was reached after seven years of protracted negotiations commenced in Punta del Este, Uruguay in 1986. Prior to the Uruguay Round of negotiations, there were seven other rounds conducted under the GATT umbrella. The Tokyo Round is the most important of these. It resulted in several ground-breaking agreements such as the Anti-Dumping Code and the Subsidies Code, though not all members of GATT are signatories to the Code.

The basic premises of the GATT law can be distilled into several propositions: first, that general welfare is enhanced through the promotion of consumer welfare and the improvement of the production sectors; second, that this can be achieved by introducing greater availability of goods and services to consumers, with a wider range of quality and prices, and by introducing competition in the process; and third, that welfare is reduced when obstructive

measures, i.e., unfair trade practices, are tolerated. The technical names for these theories are varied, and we shall not discuss them here. These theories were raised and evolved over a period of two centuries, from the time the thence-prevalent mercantilist theory was questioned by David Ricardo's comparative advantage theory.

From these theories, several basic rules were drawn up over the centuries and formalized in several treaties, culminating in the multilateral obligations created in 1947 with the signing of the General Agreement on Tariffs and Trade. In terms of scope, it is quite obvious that the treaty is quite comprehensive, having within its ambit all issues that have been carried over from the 1947 GATT (a 48-year expansion) and the new matters threshed out in the Uruguay Round. These matters concern such topics as varied as: trade in agriculture which, prior to this round was exempted from the general coverage of GATT, sanitary and phytosanitary measures (phytosanitary measures are measures related to plant life); textiles and clothing which were also not initially covered by GATT; technical barriers to trade; trade-related investment measures; preshipment inspection; rules of origin; and import licensing procedures.

IV. GATT LAW: A REVIEW OF THE BASIC RULES

The basic rules animating the fields of trade in goods and services can be clustered into four, for ease of discussion. It goes without saying of course that from these four, specific applications, exceptions, modifications and other ramifications spring forth.

The first rule is the "most-favored nation (MFN) obligation." In the 1947 GATT, it is thus worded:

> *With respect to customs duties and charges of any kind imposed on or in connection with importation or exportation or imposed on the international transfer of payments for imports and exports, and with respect to the method of levying of such duties and charges, and with respect to all rules and formalities in connection with importation and exportation, and with*

> *respect to all matters referred to in paragraphs 2 and 4 of Article III, any advantage, favour, privilege or immunity granted by any contracting party to any product originating in or destined for any other country shall be accorded immediately and unconditionally to the like product originating in or destined for the territories of all other contracting parties.* (Art. I, par. 1)

There is a counterpart provision in the General Agreement on Trade in Services (GATS), an annex agreement to the WTO, formulated as follows:

> *With respect to any measure covered by this Agreement, each Member shall accord immediately and unconditioinally to services and service suppliers of any other Member treatment no less favourable than that it accords to like services and service suppliers of any other country.* (Art. II, par. I)

MFN obligations are standard fare in bilateral friendship, commerce and navigation treaties. Concretely, it means that preferential treatment in favor of the nationals of a favored state, as a general rule, is prohibited under both GATT and GATS. If the preferences are created by virtue of an integration agreement, there are conditions the agreement must satisfy for the preferential measures to be considered as GATT- and GATS-conforming. There are exceptions to this which we will discuss later.

The second rule is the "national treatment" rule which the GATT states thus:

> *The products of the territory of any contracting party imported into the territory of any other contracting party shall be accorded treatment no less favourable than that accorded to like products of national origin in respect of all laws, regulations and requirements affecting their internal sale, offering for sale, purchase, transportation, distribution or use.* (Art. III, par. 4)

In the GATT, the rule reads:

> *In the sectors inscribed in its Schedule, and subject to any conditions and qualifications set out therein, each Member shall accord to services and service suppliers of any other member, in respect of all measures affecting the supply of services, treatment no less favourable than that it accords to its own like services and service suppliers.* (Art. XVII, par. I)

Notably, the rule on national treatment applies only to sectors which have been committed by each particular country in its schedule of specific commitments.

The third rule is the rule on "nonviolation of tariff bindings," found in Article II, par. 1(a) of the GATT which reads:

> *Each contracting party shall accord to the commerce of the other contracting parties treatment no less favourable than that provided for in the appropriate Schedule annexed to this Agreement.*

Succinctly, the rule means that each country is obligated not to impose border duties and restrictions of any kind, which are higher than that committed under the country's schedule of commitments, save in the exceptional circumstances recognized by the Agreement.

The nonviolation of tariff bindings rule has its counterpart in GATS which states:

> *With respect to market access through the modes of supply identified in Article 1, each Member shall accord services and service suppliers of any other Member, treatment no less favourable than that provided for under the terms, limitations, and conditions agreed upon and specified in its Schedule. (Art. XVI, par. 1)*

The fourth rule covers a wide array of other specific rules, and that is the rule that no measure which amounts to a disguised form of restraint on trade is to be allowed. In the GATT, this is provided for very substantially, starting from a specific delimitation of the general exceptions under Article XX, to specifics such as Article XII (balance-of-payments), Article IX (marks of origin), and Article XIX (safeguards), to the fleshing out of old principles, or the creation of new grounds under the Agreement on Technical Barriers to Trade, Sanitary and Phytosanitary Measures, Rules of Origin, and Preshipment Inspection, and then to the more-detailed Agreements on Anti-Dumping and Subsidies and Countervailing Measures.

In the GATS, this rule against disguised forms of restraint on trade in services is also embodied in specific delimitations of the use of exception clauses, the balance-of-payments clause, and the transparency and participation clauses.

V. THE URUGUAY ROUND AGREEMENTS

The Uruguay Round Agreements is a collection of seemingly unrelated legal pieces on trade. The master glue that holds them together is the so-called "Final Act," a one-page document that incorporates by reference the "Marrakesh Agreement Establishing the World Trade Organization" and the "Ministerial Decisions and Declarations." On the other hand, the "Marrakesh Agreement Establishing the World Trade Organization" incorporates several major Agreements by referring to them as "Annexes." This setup was arrived at because the Uruguay Round negotiations were conducted by different negotiating committees. These committees were not afforded the opportunity to harmonize their various agreements; the only way to thread them together was through a master agreement. The master agreement referred to the different agreements as integral parts of the overarching agreement.

Like all the other 115 signatories, the Philippines has committed itself to tariff bindings and market-opening measures which are integral to the Uruguay Round Agreements. However, this paper will adress only the issues raised in the master legal

document or "The Final Act," since this is primarily a legal paper, not an economic one. The highlights of each particular document as well as their legal implications for the Philippines, will be discussed separately.

The "Marrakesh Agreement Establishing the World Trade Organization"

The creation of the WTO sought to concretize the "single institution approach," in the same way that acceptance of the WTO Treaty commits a Member to the "single undertaking approach." Under the "single institution approach," the WTO is to be the exclusive world body under which all multilateral trade issues are to be resolved. Before the WTO, the Tokyo Round resulted in the adoption of several "Codes" to govern different problem areas in international trade. Because participation in the "Codes" was not mandatory, however, factionalism over trade issues and trade disputes became the norm. The Uruguay Round resulted in the near-complete incorporation of the various codes adopted in the Tokyo Round and a single institutional approach became possible. This includes negotiations for tariff and market access liberalization, legal rules, dispute resolution, as well as decisions or intepretations of international trade rules. Note, for example, the following features:

1. The WTO is to provide the framework for the implementation, administration and operation of the Multilateral and Plurilateral Agreements;

2. All disputes, even those arising in specific provisions of the Multilateral Trade Agreements, are to be processed through the dispute resolution mechanism of the WTO;

3. The organization created by the enforcement of GATT 1947 is to be replaced;

4. For the first time, the WTO's role as the third leg of the Bretton Woods system is formally recognized by the provision that "[w]ith a view to achieving greater coherence in global economic policy-making, the WTO shall cooperate, as appropriate, with the International Monetary Fund and with the International Bank for Reconstruction and Dvelopment and its affiliated agencies."

The outline of its organizational functioning provides for the following:

1. The highest body in the WTO is a Ministerial Conference which will be held every two years.

2. A General Council will be established to:

   a. oversee the operation and implementation of the Agreement;
   b. act at the same time as a Dispute Settlement Body and a Trade Policy Review Mechanism; and
   c. concern itself with the full range of trade issues.

3. Subsidiary bodies are to be established such as:

   a. the Goods Council
   b. the Services Council; and
   c. the TRIPS Council.

All GATT Members will be considered original Members of the WTO as of 1 January 1995, provided that they comply with the requirements of the provisions on acceptance. An acceptance prior to 1 January 1995 takes effect on said date while an acceptance after the date takes effect 30 days after the deposit of the instrument of acceptance. GATT Members are given a period of two years from 1 January 1995 or until 31 December 1996 to accept the Agreement. After this date, any country which failed to accept the Agreement but wishes to do so, can join the WTO under the provisions on "Accession" for non-GATT Members. Two-thirds of all the Members of the WTO must agree to the accession and under certain terms of accession which require the implementation of "market-opening" measures.

All members of the 1947 GATT have two years to decide whether or not they will join the WTO to be considered original members. The instrument of acceptance must be an "all-or-nothing" acceptance, save in those specific provisions where reservations and requests for exemptions from certain obligations are allowed.

At the moment, there is no alternative organization which the Philippines can join in lieu of the WTO, and all obligations under the 1947 GATT cannot be pursued except through the institutional mechanisms of the WTO. If any country refuses to accede to WTO membership, it may not avail itself of trade-opening benefits with other countries except those agreed upon bilaterally or plurilaterally with the importing or exporting country.

Once membership in the WTO is sought, a Member cannot raise as defense the inability of the government to implement any agreement due to its unconstitutionality. Neither can a Member accept the Treaty with general or specific reservations except in those very limited instances where reservation is allowed. Attention must be paid to exemption and moratorium clauses which are privileges granted to developing countries, e.g., the five-year moratorium on Customs Valuation rules. Should a country pass internal law approving only some but not all of the provisions of the Agreement, where such reservation is not specifically allowed, and such law is contrary to the provisions of the WTO Treaty, the instrument of acceptance which has been submitted may be rejected.

Agreement on Trade in Goods (Annex 1A of the Agreement)

General Agreement on Tariffs and Trade 1994

Understanding on the Interpretation of Article II(b):

This understanding requires that any "other duties and charges" which under Article II:(b) should not exceed the tariff bindings of a Member, are to be recorded in the Schedule of tariff items to which they apply. The requirement is intended to ensure transparency.

Any future increase in duties and charges on product importations in which a country has a tariff binding is a violation of the obligation not to increase tariffs as well as other duties and charges on bound items. Philippine representatives are therefore required to ensure that accurate reflection is made of all additional burdens.

Understanding on Article XVII (State Trading Enterprises)

For review purposes, members shall give the Council for Trade in Goods the identities of state trading enterprises. This mechanism aims to ensure that these enterprises observe the non-discrimination obligation. State enterprises are defined as:

> *Governmental and non-governmental enterprises, including marketing boards, which have been granted exclusive or special rights and privileges, including statutory or constitutional powers, in the exercise of which they influence through their purchases or sales the level or direction of imports or exports.*

Notification is not required if the imports influenced are not for sale or use in the production of goods for sale but are for immediate or ultimate government consumption.

The activities of state enterprises like the National Food Authority and other similar agencies are to be reviewed with regard to their compliance with the different obligations under the GATT, including the "national treatment" obligation.

Understanding on the Interpretation of Articles XII and XVII:B (Balance-of-Payment Provisions)

Although a Member may impose import restrictions for balance-of-payments reasons, it has to observe certain procedures alongside the import restrictions. First, it shall announce as soon as possible a time-schedule for the restriction. Second, it shall give preference to measures which are least disruptive of trade. Third, it shall prefer price-based measures, e.g., price control and import surcharges, rather than quantitative or absolute restrictions. Justification must be made when quantitative restrictions are used instead of price-based measures. Fourth, no more than one restrictive import measure may be applied on the same product. Fifth, measures taken under Article XII, and XVIII:B are to be used only to control the general level of imports and may not exceed what is necessary to address the BOP situation. This precludes the use of targetting measures against specific products. When

targetting measures are wrongly used, a remedy is provided to correct the wrongful application of internal measures.

In availing itself of BOP emergency measures justifying import quotas or prohibitions, the Philippines is required to observe the requirements.

Understanding on the Interpretation of Article XXIV (Customs Union, Free Trade Areas and Interim Measures)

Article XXIV deals with customs unions or free trade areas, or interim measures resulting in either. The article is interpreted by the understanding in a stringent manner. The first interpretation made is that in order to assess whether the general incidence of the duties and other regulations of commerce are higher after the formation of the customs union than before its formation (which is prohibited), an overall assessment of the weighted average tariff rates and customs duties will be used as basis. The period of an interim agreement which is intended to result in the formation of either a free trade area or a customs union shall not be more than ten years. The procedure for the modification or withdrawal of concessions attendant to the formation of a customs union is specified in the article. All interim agreements without a plan and schedule shall be reviewed by a working party created for the purpose. The working party may recommend a plan and schedule. The Members of this interim agreement shall not maintain or enforce it unless they are willing to modify the same in accordance with the recommendations of the working party.

Understanding on the Interpretation of Article XXXV (Waivers)

Before a request for a waiver may be granted, the requesting party is required to specify the following: (1) measures the Member state proposes to take; and (2) the policy objectives and the reasons which prevent the Member from achieving its policy objectives by GATT-consistent measures. Existing waivers shall lapse on their date of expiry or two years from the enforcement of the Agreement, whichever is earlier, unless there is an extension sought under the provisions of Article IX. A Member who suffers an injury due to the action taken under the waiver may seek redress under Article XXXIII.

Understanding on the Interpretation of Article XXVIII (Modification or Withdrawal of Concessions)

Under Article XXVIII, countries which have a "principal supplying interest" may negotiate over the damages or compensation due them when any schedule of concession made by a Member is modified. A Member with a "principal supplying interest" is one which has the highest ratio of exports affected by the concession relative to its total exports. In other words, absolute volume of trade in the goods to be affected by the modification or withdrawal of the concession is no longer used as the principal measure of negotiating rights. The purpose is to effect "a redistribution of negotiating rights in favor of small and medium-sized exporting Members." If this does not improve these countries' negotiating position, then the criterion is to be modified with the possible adoption of a criterion based on the ratio of exports affected by the concession to exports to all markets of the product in question.

If government officials are vigilant over the country's rights, the Philippines has a genuinely good chance of improving its negotiating position. There are provisions in this Article designed to offset damages the country may suffer when any concession it had previously enjoyed under GATT would be withdrawn or modified.

Marrakesh Protocol to GATT 1994

The national schedules of tariff concessions are an integral part of the treaty itself. The national schedules are to be implemented according to a schedule of reductions. Except for the schedule of agricultural products, and unless otherwise specified in a member's schedule, the tariff reductions are to be implemented in five equal annual rate reductions to be effective on January 1 of each year.

Upon the Senate ratification of the Uruguay Round agreements, the Philippines legally bound itself to comply with the tariff bindings. But the Philippines must not become too eager to cut down tariffs without considering the strategic timing it may employ in the reductions, especially because the Agreement envisions not a one-step reduction but graduated reductions.

Agreement on Agriculture

This Agreement is one of the most extensively discussed in the Uruguay Round. Prior to this, the policy of protectionism for agricultural products was manifested in different forms of trade barriers such as quotas, importation bans, income subsidies and price subsidies. The intent of this new Agreement is to ensure that agricultural products come fully within the GATT discipline. It must be noted, however, that there are special provisions made in favor of developing countries which deserve careful study.

The most basic legal obligation of the Philippines is its specific commitment in the areas of market access, domestic support and export competition. Of all the agreements reached in the Round, this special commitment must be carefully scrutinized. There are several general categories of commitments to which the Philippines is bound, as follows:

1. Tariffication. All non-tariff measures are to be replaced by tariffs to be reduced in stages. Developing countries have a ten-year period to implement their commitments.

2. Minimum access tariff quotas. Where current access of imported products is less than three percent of domestic consumption, a Member is required to expand this access to five percent for the duration of the five-year implementation period.

3. Support Reduction Commitments. For developing country Members, a *de minimis* reduction of 10 percent of its Aggregate Measurement of Support (AMS) must be made. However, in measuring AMS a great deal of consideration is given to developing countries since the fundamental requirement of any development program is agricultural development which requires government assistance.

4. Export Competition Commitments. Members are required to reduce their subsidies to exporters of agricultural products. The subsidies and support included in the reduction commitment are direct payments subsidies,

income subsidies, sale for export at prices lower than the domestic level, financing, marketing subsidies, transport subsidies, and "process" subsidies.

5. Commitments on Preconditions to Export Prohibitions. When an action to prohibit exportation of a product is made, Members are required to ensure due consideration of importing Members' food security by giving notice to the WTO Committee on Agriculture.

There are policies and subsidies which are not included in the computation of AMS. These subsidies include general government services, e.g., research, disease control, infrastructure and food security, as well as income support, structural adjustment assistance and direct payments under environmental programs or regional assistance programs.

In cases when economic injury is sustained by the importation of local agricultural producers, there are special safeguard provisions under Article 5. Additional duties may be imposed on products which are subject to a tariffication commitment should there be a surge in imports or should prices fall below a certain trigger price denominated in the local currency.

In particularly sensitive situations, protection of an agricultural product may be maintained under the so-called "special treatment" clause (Annex 5 of the Agreement on Agriculture). The conditions for the maintenance of import restrictions on these products, which cannot be maintained past the implementation period, are: that importation of the primary agricultural product is less than three percent of domestic consumption in 1986-88; that no export subsidies are supporting the product; and that there are production restricting measures imposed on that product. However, a minimum access opportunity is required, starting at four percent of domestic consumption in the first year and rising gradually to eight percent on the sixth year.

Special and differential treatment in favor of developing countries is embodied in the following:

1. An extended period for the implementation of reduction commitments. While developed countries have a period of six years to implement their commitments, developing countries have 10 years to do so.

2. Government assistance to encourage agricultural and rural development. Investment subsides generally available to agriculture and agricultural input subsidies are not to be included in the calculation of total AMS.

3. Export subsidies reduction commitments are two-thirds that of developed countries' commitments.

4. The obligations on export prohibition measures do not apply to developing countries unless they are net food exporters of the product the exportation of which is prohibited.

The provisions on agriculture were intended primarily to open up the markets of developed countries. The Philippines is undergoing legal adjustments to the disciplines under the Agreement on Agriculture. Several laws require repeal or amendment, principally those imposing quantitative restrictions. Foremost among these is the Magna Carta for Small Farmers (RA 7607). The other laws imposing agricultural quotas are RA 2712 (coffee), Presidential Decree (PD) 1297 (beef), RA 7607 (seeds), RA 4155 and PD 1485 (tobacco).

Agreement on Sanitary and Phytosanitary Measures

The intent of the Agreement is to ensure that sanitary and phytosanitary measures are not used as a disguised form of nontariff barrier. Members are encouraged to harmonize sanitary and phytosanitary measures by applying as the base of their measures international standards and guidelines, whenever applicable. They may introduce higher standards only when there is scientific justification for such increased standards or as a result of a

consistent risk decision based on an appropriate risk assessment. Equivalence is to be granted to other Members' level of health protection. Members are required to observe principles of transparency, such as the publication of rules, establishment of information or inquiry points, and notification procedures.

The Philippines can push for greater acceptance of its exports in countries with very high sanitary and phytosanitary measures as long as it can be shown that our products satisfy international standards, or that the importing country's level of health protection is not diminished by the entry of our goods. This works both ways. Our standards may be subject to the complaints of an exporting country for the same reasons.

Agreement on Textiles and Clothing

There is to be a gradual integration of the trade in textile and clothing by means of the eventual abolition of the Multifibre Arrangement (MFA) and its inclusion in the GATT 1994 legal framework within a period of 15 years. Other arrangements which are not justifiable under GATT but which are not necessarily under the MFA are to be brought into GATT discipline within one year of the Agreement's enforcement, or phased out progressively. There is a schedule to be followed for the integration of trade in textiles and clothing into the GATT system.

A transitional safeguard clause targets products which have not yet been integrated into GATT. At any stage, when it is shown by the importing Member that the imports of a product were entering the country in such increased amount as to cause serious damage or to threaten the domestic industry and that there was a substantial increase of imports from a particular country, safeguard actions can be taken either unilaterally (but subject to review by the Textile Monitoring Body which is established under the Agreement), or by mutual agreement after consultations. There are also mechanisms to prevent circumvention through transshipment, rerouting, false declaration of origin and falsification of documents.

Agreement on Technical Barriers to Trade

This Agreement intends to ensure that technical standards such as certifications and testing are not used to create barriers to trade. Like the requirements under the Agreement on Sanitary and Phytosanitary Measures, this Agreement encourages Members to use international standards when appropriate, but it does not require them to lower levels of protection. A Code of Good Practice for the Preparation, Adoption and Application of Standards by standardizing bodies has been annexed to the Agreement. The Agreement covers standards imposed not only by the national government but also by local governments.

Agreement on Trade-Related Aspects of Investment Measures

One of the more radical features of the Round, this Agreement requires as a basic rule that no Member is to apply any investment measure which is inconsistent with Article III (national treatment) or with Article XI (quantitative restrictions) of the GATT. It annexes an illustrative (not exhaustive) list of measures which are considered to be GATT-violative. We can classify these into three: local content rules, imported component restrictions, and foreign exchange restrictions related to the amount of foreign exchange inflows.

Some of our major industrialization programs like the Progressive Car Manufacturing Program have built-in local content requirements because these are essential to strengthening local industry capabilities at least in some aspects of production. With this Agreement, the Philippines will have to find a better approach to developing its industrialization programs. Under the standstill clause, each member is expected to refrain from undertaking any additional Trade Related Aspects of Investment Measures (TRIMs). For those TRIMs that are in existence, a transition period is provided. Developed Members must remove TRIMs within two years; a developing country within five years; and a less-developed country within seven years.

Anti-Dumping Agreement

The Anti-Dumping Agreement provides that:

> *... a product is to be considered as dumped, i.e., introduced into the commerce of another country at less than its normal value, if the export price of the product exported from one country to another is less than the comparable price, in the ordinary course of trade, for the like product when destined for consumption in the exporting country.* (Article 2.1)

The Philippines does not have an effective system of resolving anti-dumping disputes. Section 301 of the Tariff and Customs Code, the old law on anti-dumping, did not provide clear standards and guidelines for determining the existence of situations of dumping. In response to fears that the acceptance of the WTO will result in the flooding of cheap dumped imports, RA 7843 or the New Anti-Dumping Law was passed. It defines dumping as occurring when "a specific kind or class of foreign article is being imported into, sold, or is likely to be sold in the Philippines at a price less than its normal value, the importation or sale of which might injure or retard the establishment or is likely to injure an industry producing like articles in the Philippines." There are proposals to amend this law in view of doubts expressed by some sectors on its ability to protect the interests of local industries. There are also doubts that the procedural requirement of due process in the Anti-Dumping Agreement may not be met.

Customs Valuation Agreement

Under the 1947 GATT, the customs valuation shall be the "actual value" of the imported merchandise. This has led to a lot of debate on the meaning of actual value. This Agreement definitely sets forth the "transactions value" of the product—i.e., the price actually paid or payable for the goods when sold for export to the country of importation after adjustments are made—as the legal standard for "actual value." Developing country members who wish to delay the implementation of this Agreement may do so over a period of five years provided they notify the WTO.

This Agreement requires the Philippines to change the "home consumption value" method to "transactions value." Since harmonization will require time, the Philippines can take advantage of the five-year lag under the special treatment to be given to developing countries. The intention and requirement of both the 1947 GATT and this Agreement is to ensure a degree of predictability and consistency in the use of valuation methods by importing countries so that traders can estimate in advance customs duties and other charges to be imposed on their goods.

Agreement on Preshipment Inspection

The Agreement recognizes the need of developing countries to use private preshipment inspection (PSI) agencies. However, the Agreement wants to ensure that the activities of PSI agents always conform with the hiring government's obligations under GATT. The obligations imposed on government PSI-users are nondiscrimination, national treatment, transparency, protection of confidential business information, insurance on the absence of conflicts of interest of PSI and the exporter's competitor, and prevention of delays, among others.

The Philippines must make sure that its current preshipment private inspector, *Societe Generale de Surveillance* (SGS), or any other company it will hire in the future, strictly observes these requirements of the Agreement. Otherwise, the Philippines will be held accountable for any violation of the Agreement by the PSI, even if these entities are private in nature.

Agreement on Rules of Origin

The intention of this Agreement is to ensure the harmonization of rules of origin (except those specifically granting tariff preferences allowable under GATT rules). There is a three-year period, which is to commence shortly after the effectivity of the agreements, within which rules of origin for uniform application are to be ironed out under the auspices of a Committee on Rules of Origin.

Under the Philippines' current preferential trade treaties, government authorities are required to ensure that the origin of the goods is correctly declared in the shipment documents. Should a clarification of rules of origin be reached in the Committee on Rules of Origin, the Philippines may have to amend existing laws or rules providing for a different definition.

Agreement on Subsidies and Countervailing Measures

The Subsidies Code was incorporated and even strengthened. All countries maintain one form of subsidy or another. Many, however, have not been held liable under the GATT either because they are not signatories to the Subsidies Code of the Tokyo Round, which means they are only liable under the definition-less provisions of the 1947 GATT, or if they are signatories to the Subsidies Code, the injury and specificity requirements for the application of the Code have not been met. On the other hand, this Agreement is also intended to eradicate the practice of powerful countries of unilaterally applying their Subsidies and Countervailing Duties Law to the prejudice of the exporter. With the Subsidies Code, specific subsidies are minimized and the unilateral imposition of countervailing duties by powerful countries will be prevented.

Under Article 1.1 there is a subsidy when:

1. there is a financial contribution by a government or public body within the terrritory of a Member where: (i) government practice involves a direct transfer of funds (e.g., grants, loans, and equity infusion), or (ii) potential direct transfers of funds (e.g., loan guarantees);

2. government revenue that is otherwise due is foregone or not collected (e.g., tax credits);

3. government provides goods or services other than general infrastructure, or purchases goods;

4. government makes payments to a funding mechanism, or entrusts or directs a private body to carry out one or more of the type of functions illustrated above which would normally be vested in the government and the practice in no real sense differs from practices normally followed by governments; or

5. there is any form of income or price support; and

6. by virture of such measures, a benefit is conferred.

A subsidy is subject to GATT rules only when it is specific to an industry, enterprise or group of industries and enterprises, and it is specific to such entities when:

1. there is explicit limited access to such subsidy to certain enterprises; and

2. in all other cases where it can be shown that the subsidy is in fact specific, as in the following instances: use of a subsidy program by a limited number of enterprises, the grant of disproportionately large amounts of subsidy to certain enterprises, predominant use of subsidies by certain enterprises, and the manner by which discretion is exercised by the granting authority.

The legal effects of these subsidies are determined according to which category they fall under: prohibited subsidies, actionable subsidies or non-actionable subsidies.

Under the first category, a subsidy is prohibited when either the subsidies are contingent on export performance, or they are contingent upon the use of domestic over imported goods. If another Member can show that a subsidy maintained or introduced by another Member is prohibited, the subsidy must be immediately withdrawn; otherwise, the complaining Member may take countermeasures. Actions under this paragraph are subject to the expedited procedure provisions of the Understanding on Dispute Settlement.

Under the second category, a subsidy is actionable if there is injury to the domestic industry of another Member; there is impairment or nullification of benefits to other Members; or there is serious prejudice to the interests of another Member. If the Dispute Settlement Body determines that the subsidy causes such adverse effects, then the subsidizing Member must withdraw such subsidy.

Under the third category, in instances of non-actionable subsidies such as assistance to industrial research, precompetitive development activity, and assistance to disadvantaged regions, another Member may seek a determination and recommendation on the matter of the subsidy.

Least-developed and developing countries with a per capita gross national product (GNP) of less than $1000 have a ten-year period within which to eliminate prohibited subsidies while other developing countries have an eight-year period within which to eliminate them.

Under our economic development program, we offer tax credits and tax exemptions to industries where a specified portion of production is devoted to export. Financial arrangements are also offered for more lenient availment when the industry is export-oriented. Such programs might fall within the category of prohibited subsidies. The Philippines must prepare for the eventual elimination of such subsidies within the timetable allowed but with a legal caution, e.g., in the form of a sunset clause to terminate these programs a year or two prior to the termination of the withdrawal period.

On the other hand, we must fully utilize the protection offered by our Countervailing Duties provisions to local industries unfairly prejudiced by subsidized imports. The procedural and substantive requirements must be strengthened to make them GATT-conformable. We must diminish the chances of being adjudicated as violating our GATT obligations to strengthen our negotiating position.

Agreement on Safeguards

In contrast to prevailing rules under Article XIX, the Agreement establishes prohibitions against "grey area" measures and sets up a "sunset clause" on all safeguard actions. It expressly includes a prohibition against voluntary export restraints, orderly marketing arrangements, or any other similar measure, which are currently being used by the United States and European Union countries. Each Member is allowed to maintain one exception to the safeguards limitations, subject to the rule that the measure will be phased out by the end of 1999.

The Philippines does not have a comparable "safeguards clause." It is recommended that it enact one, especially in view of the implementation of the market access and minimum access volume commitments in the Agreement on Agriculture. In the process, it will have to ensure that any import restriction it imposes is justified under the provisions of Article XIX.

General Agreement on Trade in Services

The General Agreement on Trade in Services imposes three basic obligations: the MFN obligation, the subjection of specific services sectors to liberalization negotiation, and after the specific service sector has been opened, the subjection of the sectors to the national treatment rule. Under the MFN rule, each Member is to accord the nationals of all Members treatment no less favorable than the treatment given to the nationals of other countries. Under the progressive liberalization obligation, the services sector is subject to negotiations. After a service sector has been committed to be opened, a Member is required to afford the nationals of another Member the same treatment it gives its own nationals.

Unless there is a statute opening a particular professional service area, no market-opening commitment can be made. This may run counter to the Constitutional provision (Art. XII, Sec. 14, 2nd par.) that "the practice of all professions in the Philippines shall be limited to Filipino citizens, save in cases prescribed by law." The effect is that before the Philippine delegation can make any specific commitment, especially in services, a law must first be passed to

allow the entry of foreigners into a specific profession. Only then can any profession be the subject of negotiation. It has also been the opinion of a legal scholar that the practice of law is primarily within the power of the Supreme Court to regulate and therefore it would be unconstitutional even for Congress to specify more lenient nationality requirements for the practice of law.

Services specifically requiring a professional license are: engineering, medical and allied professions, accountancy, architecture, criminology, chemistry, customs brokerage, forestry, geology, marine deck offices, marine engine offices, master plumbing, sugar technology, social work, librarianship, and law.

With respect to other services, there are constitutional provisions and laws requiring ownership percentages for the rendition of services in the following areas: private recruitment, construction of publicly-funded works, advertising, exploration, development and utilization of natural resources, public utilities, educational institutions, and the like.

Agreement on Trade-Related Aspects of Intellectual Property Rights (IPR), including Trade in Counterfeit Goods

Part I of the Agreement sets out general provisions and basic principles, notably a national treatment commitment under which nationals of other parties must be given treatment no less favorable than that accorded to a party's own nationals. It gives most-favored nation rights to nationals of all other parties, with an advantage to nationals of other parties in the sense that any advantage a party gives to nationals of another party must be extended immediately and unconditionally to nationals of other parties, even if such treatment is more favorable than what the party gives its own nationals. It also incorporates by reference certain provisions of the Paris Convention and provides that nothing in the Agreement should be construed to derogate from the Members' obligations under the Paris Convention, the Berne Convention, the Rome Convention and the Treaty on Intellectual Property in Respect of Integrated Circuits.

Part II sets outs the standards on the availability, scope and use of intellectual property rights. It requires compliance with Articles 1 through 21 of the Berne Convention. It specifies protection to computer programs, data compilation, performances and phonograms. Trademarks, patents, industrial designs, geographical indications, and designs of integrated circuits are specifically governed by special sections. There is a special section which seeks to curtail anticompetitive practices in licensing agreements.

Part III provides requirements for adequate enforcement of intellectual property rights. Each Member is required to offer protection in both civil and criminal actions. It is required that civil actions be made available against infringers of IPRs and that those who infringe on a commercial scale be criminally prosecuted. Willful piracy of copyright and trademark counterfeiting must be considered criminal acts. Members have a transitional period of one year as a minimum, and four years thereafter for developing countries, and in case of particular difficulty in areas of new technology, another five years for developing countries.

Pharmaceutical and agricultural chemical industries are to be protected even in developing countries, on the condition that these industries can have only a five-year marketing monopoly on these products.

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General Agreement on Tariffs and Trade.

COMMENTS

*Sedfrey Candelaria**

Prof. Ma. Lourdes Sereno's paper on the Legal Rights and Obligations in International Trade Arrangements is an exhaustive yet concise treatment of the treaty regime. Let me just emphasize three points. One is the historical development of the legal obligations under the international trade regime. The second is the consequences of non-compliance with these legal obligations. The third point has to do with the liberal perspective that informs the dispute settlement mechanism.

One of the initial difficulties in the development of rules governing international economic relations was the prevailing reluctance among nation states during the early part of the century to submit themselves to a fixed legal regime. But the beggar-thy-neighbor policy, which promoted extreme economic nationalism among industrialized nations and which triggered the trade war before World War II, underscored the harshness of an international economic environment which paid only lip service to customary rules of commerce. One noted legal scholar at the time, Prof. George Swazenberger, observed that during the interwar period states had practically abandoned the assumption that for as long as the economic mechanisms of international trade were allowed to operate more or less automatically, a bilateral framework for the standards of international economic law would suffice. Prof. Quincy Wright, another international legal scholar, had earlier argued that the economic sovereignty of states must be limited by rules of positive law if a more stable and prosperous world order is to be achieved.

The impression one might gather is that there were initially no rules with regard to economic relations of states. What Prof. Sereno called "most-favored nation," "national treatment," "open door," were actually clauses already contained in bilateral commercial treaties between states even in the 19th century. But the idea before World War II was to find out whether these [treaties] could contain all these economic relations. The increase in the number of countries after World War II perhaps had a significant impact on the development of rules of the game particularly in trade law. Prof. Sereno referred to the significance of some of the

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provisions relating to the situation of developing countries not just in the General Agreement on Tariffs and Trade (GATT) but even in the World Bank and the International Monetary Fund (IMF) for the purpose of balance of payments financing, for instance. There are provisions intended to address the plight of majority of the members who are developing countries.

These legal regimes were created to provide the appropriate climate for cooperation and development. Non-compliance with the provisions of the treaty regime must be viewed in this light. In the case of the GATT or even the IMF or the World Bank instruments, member states are not automatically threatened with state or international responsibility in the event of deviation from the norms of trade or financial law. The treaty regimes in economic relations must be viewed more as a means of developing a collective responsibility among member states rather than as a coercive legal tool for less economically capable members. Otherwise, majority of countries will opt for non-membership. Indeed, the GATT provides for leeways, emergency clauses, and staggered periods of compliance between developing and industrialized members. These foster confidence among states that the treaty regime must be availed of to promote its members' best economic interests.

It is evident from a survey of the provisions of GATT that a specific regime of responsibility for the breach of obligations is provided. This brings me to the last point. The dispute settlement mechanism embodied in GATT-WTO is more elaborate relative to the system under the 1947 agreement (which created the stillborn International Trade Organization). This may be ascribed to the desire to avoid unilateral actions by member states. Instead, the dispute settlement body is the one empowered to authorize retaliatory measures in cases of non-implementation of recommendations. As a rule and as a matter of practice, consultation is a principal mode of addressing perceived violations before a complaint is lodged with the WTO Director General's Office for settlement either through good offices, consultation or mediation. This is really the mode of settling disputes in international law. If these modes of settling disputes do not produce results, the next recourse is the structured panel system where the complaint is finally taken up.

What can one conclude from this process? First, I think there must be public knowledge that adhering to an international treaty regime of this nature should really not scare us so much. In fact, we should look at the advantages. My view is that being out of the system will make things worse for us. This was evident even in the context of IMF membership or even in the context of membership with the World Bank. What used to be socialist economies are in fact now trying to enter the system.

From a legal perspective there are now very serious demands upon Filipino legal practitioners. We may have to develop very good trade lawyers who will represent the government. We should not rely on experts in the United States or in Europe to represent us. Moreover, we need to coordinate and evolve a system of data-gathering to provide our lawyers adequate information should the country be called upon to respond to summons of the dispute settlement body.

14. Features of the Emerging World Economic Order: Implications on Growth Policy

Raul V. Fabella

INTRODUCTION

The success or failure of an economic policy package and the underlying growth strategy it is designed to serve depends on varied domestic considerations as well as the global environment. Domestic considerations include the adequacy of implementation, the response of domestic economic agents, the sequencing of the various aspects of the package, the credibility and consistency of the package itself, and the political resistance from those who will foot the bill of adjustment. The global environment also has to be favorable to make the initiative a success. For example, the Vietnam War and the devil-may-care Western spending spree in the 60s gave South Korea and Taiwan a tremendous boost in the world market. On the other hand, the strategy of industrializing based on borrowed recycled petrodollars created a nightmare when world interest rates began to climb. Of course, domestic profligacy also contributed to the foreign debt crisis of the 80s.

Divining the structure of the emerging world economic order is like forecasting a hairy business. Since we are only as wise as our history, we can only marshall recent as well as remote historical events as our guide to the most enduring and growth-relevant features of this emerging economic order. Our choices of facts-on-the-ground are naturally highly subjective and personal but they are not, we believe, eccentric. The challenge is to derive the implications of these facts on the alternative growth paths open to us.

I. GLOBAL FACTS

A. 1989 and the Emergent Transition Economies

1. 1989

The year 1989 is a watershed in the emerging world economic order. The collapse of the centrally planned economies in East Europe enshrined the dominance of the market *weltstanchauung* over state planning. Rightly or wrongly, it anointed Adam Smith as the millenial visionary at the expense of Karl Marx. It marked the end of an era of bipolar military confrontation which spawned economies that survived and thrived on the coattails of ideological loyalties (Cuba and Albania, for example). The world suddenly discovered that the market worldview is varied and allows for contrasting nuances: the People's Republic of China (PRC) has "market socialism;" Germany has the "social market model" not quite like the Mellon-Fordist Capitalism nor the emerging "Chile model;" the historical "East Asian model" is at variance with the World Bank and the International Monetary Fund (IMF) ideals. In brief, the race of ideas continues on a narrower avenue.

For the Philippines, 1989 also unleashed a number of new aggressive market gladiators who, by virtue of their military history, tested organizational prowess and adherence to the "Lee Kuan Yew doctrine," promise to make life harder for other global market tenants. China and Vietnam have already drastically changed the economic race course, the direction of foreign direct investment in Asia being only one example. Eastern Europe itself is attracting European and East Asian (e.g., Daewoo) resources away from other needy areas like Latin America and Africa. Competition for both markets and resources will become even more bruising.

In the West, the Thatcher-Reagan conservative revolution of the 80s is less shrill but still very much on course. This means a Western world very sensitive to trade deficits and loss of jobs and ready to pounce on imagined or real unfair trade practices, especially by emerging economies.

Compared with the emerging economic order, the mid-century environment that spawned the first tier economic miracles (Germany

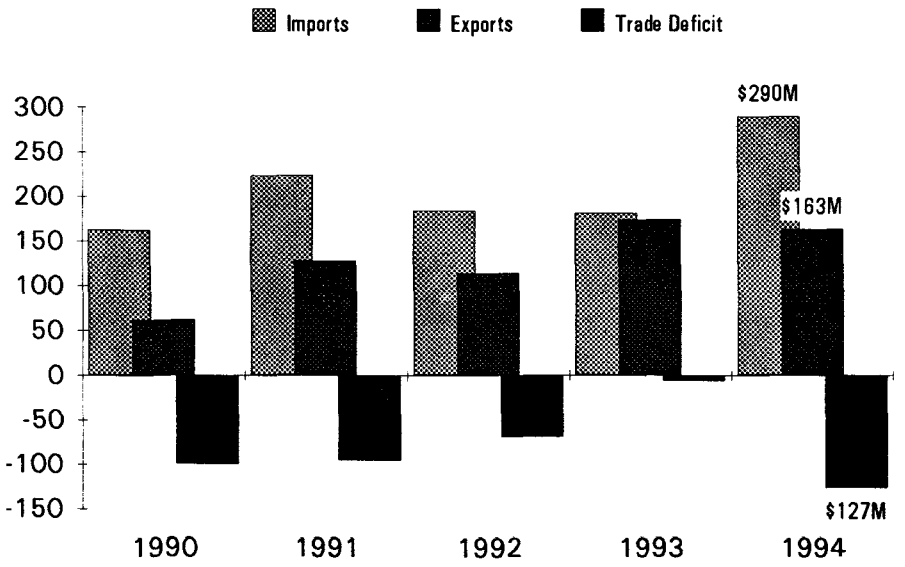
and Japan) and the second tier Asian Tigers (newly industrializing countries or NICs), seem genteel. Before the thawing of the Cold War, the superpower confrontation, the arms race and the persistent rumor of a nuclear holocaust determined the dynamics of trade. Recovering Japan and West Germany got a tremendous shot in the arm from the expansionary pull of the Korean War. Taiwan and South Korea rode on the sky-is-the-limit spending orgy in the West spawned by the Vietnam War. They were then being nurtured as emerging bulwarks of the "free world" and their potential for becoming market adversaries hardly mattered. As a global political strategy, the "free market bulwarks" approach worked beyond expectations. As the East Asian economies became rich, they were often cited as *prima facie* evidence of the superiority of the market. In the end, it was the people themselves (rather than warheads) deciding that there was a better option that undid the great Soviet Union-led central planning experiment of the Second World socialist countries.

2. *People's Republic of China (PRC)*

Undoubtedly the largest fact-on-the-ground in the emerging economic order for the Philippines is the PRC. The Spratly Islands dispute dominates other concerns in PRC-Philippine relations. But it is in the economic arena that China's gigantic shadow looms the largest. China's rice purchases in the world market sent the world price over $400 per ton and squeezed the rice import-dependent Philippines. Chinese-made goods are flooding Philippine retail outlets, sending shivers down the spine of domestic manufacturers. The closure in 1995 of the high profile sports shoe manufacturer "Rubberworld" was a warning shot for others.

The Philippines has always had a trade deficit against China, though the trade deficit of $127 million in 1994 was less than the deficit in 1989 ($170.9 million) (see Figure 14.1). The concern over the deficit translated into the "trade balancing program" in August 1989. This required that imports from PRC be matched by exports to PRC except for imported inputs for exports, crude oil, imports of Board of Investments (BOI) priority projects and imports of the government. This lowered the trade deficit progressively until it stood at $8.8 million in 1993. However, on the occasion of his visit to PRC, President Fidel V. Ramos lifted the "trade balancing program" and the deficit again soared in 1994.

Figure 14.1. Philippine imports, exports, and trade deficit vs. China (1990 - 1994) (in US$ millions)



Source: Appendix Table 14A.2

The composition of China's export to the Philippines is varied. In 1994, consumer goods consisting of toys, canned goods, garments, and accessories accounted for 12 percent of the total. Raw materials such as crude oil, oil cake from soya beans, and soybeans accounted for 69.4 percent of the total. Capital goods such as transport buses, small power generators and engines accounted for 13.2 percent. On the other hand, Philippine export to PRC is concentrated on manufactured inputs (81 percent) such as liquefied petroleum gas, copper cathodes, naphtha, and copper concentrates; and agri-based exports (11.2 percent) such as copra, coconut oil, and ores.

Chinese investment in the Philippines is growing. In 1994, PRC-sourced investment in the Philippines amounted to 454.57 million pesos or 0.74 percent of total foreign investment. The largest PRC investors are in utilities and power generation: Chinese-Filipino Friendship Company (utilities) and Chiang Chang Jiang Energy Corporation (power generation).

China's capacity to attract foreign investment and take away jobs worries Philippine investors and policy makers. Already, the Philippines has lost chip-maker Unidem to PRC. Every proposed investment, especially in tradeables, has to pass the "China test": what is China doing and intends to do in this area? Businessmen in garments exports concede that it is only a matter of time before China pushes them out of the market. Keeping clear of the China train is a prudent strategy and the nontraded goods sector is the obvious beneficiary. This situation is worsened by two things: China's aggressiveness in the exchange rate front and the Philippines' continued maintenance of a strong peso.

PRC's integration into the global market, a legacy of 1989, changes the dynamics of growth for all developing countries (LDCs).

B. World Trade Organization

By the time the Uruguay Round ended in 15 December 1995, the traditional area of GATT-regulated trade—manufactures minus textiles—had become a substantial part of Third World trade. In 1970, LDCs contributed only seven percent of the world exports in manufactures. It was 12.5 percent in 1986 and 20 percent by 1992. As percentage of total LDC trade, manufactures rose from 30 percent in 1970 to 50 percent in 1986 and 60 percent in 1992. The Uruguay Round pulled down average tariff on LDC exports to developed countries (DCs) from 6.3 percent to 3.9 percent. The average tariff on LDC exports to other LDCs fell from 13.5 to 9.8 percent.

Aside from this traditional venue, the Uruguay Round pulled agriculture—especially food trade where LDCs and DCs compete head on, and garments—under the aegis of normal trading rules. Since both are major concerns of LDCs, 31 LDCs eventually joined GATT in the course of the negotiations. Now even former centrally-planned economies are queueing up to join the General Agreement on Tariffs and Trade (GATT) and its successor, the World Trade Organization (WTO). Every country of consequence is now either a member or is in the process of applying for membership. Thus, 1989 also made the WTO even more comprehensive and encompassing, covering all traded goods from all countries.

Apart from breadth, the WTO has much more depth than its predecessor agreement. It has established a framework for regulating trade in services. These include rules on capital and labor exports and the opening up of communications, distribution, finance, transport, tourism, construction, and other services. These sectors used to be heavily regulated in the interest of national sovereignty.

Intellectual property rights (IPR) used to be protected by copyrights and patents under separate conventions. The WTO strengthened the rules protecting intellectual property and provided for an enforcement mechanism to deal with countries that violate these rights.

Overall, the WTO has multilateralized dispute settlement and trade disputes are now governed by a framework of automatic settlements. There is more room for negotiation with the WTO as venue than with the United States Department of Trade under the shadow of Super 301.

The WTO is the embodiment of the ideal of one world freely trading under agreed upon rules reflecting in theory a level playing field. It has a mechanism for identifying and penalizing shirkers and free riders. As everyone with some exposure to game theory knows, when everyone is cooperating, the returns to free riding are greatest and will be appropriated by those who free ride. But if everyone free rides, everybody loses. Playing by the rules and winning in the WTO world entail greater efficiency and competitiveness. In this brave new world, one can no longer hide behind ideological purity to survive. You have to produce goods and offer services of value to the world in order to prosper.

C. Regional Trading Blocs

Regional trading blocks are now part of the emerging new world. The North American Free Trade Area (NAFTA), embracing the United States, Mexico and Canada (and soon Chile), was the most influential addition to the family of regional trading blocks in the 90s. NAFTA was nurtured into reality by the threatening shadow of Fortress Europe following the Maastricht Treaty. Since Mexico competes with many LDCs in the US market, NAFTA stands to

improve the relative position of Mexico. The emergence of NAFTA and Fortress Europe also roused the once somnolent Association of Southeast Asian Nations (ASEAN) into activity. In January 1992, the Singapore Declaration creating the ASEAN Free Trade Area (AFTA) was signed by ASEAN member states. This calls for a gradual reduction of tariffs to the range of zero to five percent over 15 years (or by 2008) under the Common Effective Preferential Tariff (CEPT) scheme. Beyond CEPT, the Singapore Declaration identifies several areas of cooperation, including the removal of barriers to foreign investments, harmonization of standards, reciprocal recognition of certification, and macroeconomic consultation.

AFTA goes beyond the WTO which does not presume to create a world free trade zone. ASEAN member countries will still uphold their WTO commitments *vis-á-vis* the rest of the trading world. Thus, AFTA is characterized as outward-looking since it does not raise tariffs *vis-á-vis* the rest of the world. Still, like NAFTA it will divert ASEAN trade from non-member countries to member countries even as it creates trade within Asia itself. The Philippines' own Tariff Liberalization Program under Executive Order (EO) No. 264 will gradually adjust tariffs downward until a uniform tariff of five percent is reached. This will be the Philippine posture *vis-á-vis* the world and not only the AFTA countries. Thus, AFTA presents one example of an induced regional liberalization program that transcends AFTA itself.

The challenge posed by Fortress Europe makes AFTA look small. However, combined with the muscle of Japan and the NICs, it would be a formidable entity. Thus, Malaysian Prime Minister Mahathir's East Asian Growth Area (EAGA) was born. But the EAGA pointedly excluded Australia, New Zealand and the US. Because Japan and the East Asian miracles did not approve of this exclusion in view of the US's place in their overall interests, the Asia Pacific Economic Cooperation (APEC) was formed as an alternative forum. APEC's vision (apart from marginalizing EAGA) is a Pacific Basin Free Trade Zone. The framework agreements are just being conceptualized and still bears watching.

The world is seeing in the 90s two seemingly conflicting trends: a globalizing and integrating trend symbolized by the WTO and a fragmentizing trend in the form of regional trading blocs. Fortunately, trading blocs are currently reinforcing rather than subverting the WTO in that they expressly disavow turning back on their WTO commitments. The adherence to the WTO regime means that the emerging trading blocs will minimize trade diversion and emphasize trade creation, thus raising the likelihood of overall (world) welfare improvement.

D. Globalization of Capital

1. Foreign Direct Investment (FDI)

The phenomenon that is bound to change the texture of growth among the world's LDCs is the globalization of capital. In the 70s the movement of capital to the LDCs was facilitated mainly by massive foreign borrowing of recycled petrodollars. This eventually soured and in the 80s turned into a foreign debt nightmare for many LDCs. The debt crisis decade saw private capital flows dwindle and disappear as net resource transfers began to go against developing countries. The Philippines is a good example.

In the 90s, private capital in the form of FDI has come back with a vengeance. Table 14.1 shows the world total and region inflow of FDI from 1990 to 1994. The last row shows that FDI peaked in 1990 ($235 billion), stumbled in 1991 and 1992 to reflect the recession in the West and the collapse of economic bubbles, and has since recovered.

What is of interest is that despite the stumble in total FDI in 1991 and 1992, Asia's level and share have continued its upward trend. Among Asian countries, the biggest winner is China whose ongoing economic miracle is based squarely on FDIs. Malaysia was a favorite destination, followed by Thailand and Indonesia. The Philippines' FDI level is rising but remains very small as a share in Asia's FDI.

Table 14.1. Inflow of foreign direct investment to major regions and the Philippines (in US$ million, %)

	1990	1991	1992	1993	1994
(1) NAFTA	58,324	29,502	26,490	50,496	63,441
	24.8%	15.1%	13.9%	24.2%	31.2%
(2) EUROPE (EC)	68,498	56,637	63,298	53,527	39,620
	29.1%	29.0%	33.3%	25.7%	19.5%
(3) ASIA	17,506	19,670	24,240	43,463	48,605
	7.4%	10.1%	12.8%	20.8%	23.9%
(4) EAST ASIA	5,805	3,757	4,959	1,533	3,023
	2.5%	1.9%	2.6%	0.7%	1.5%
(5) ASEAN	11,974	12,917	11,653	14,515	13,566
	5.1%	6.6%	6.1%	7.0%	6.7%
(6) CHINA	3,487	4,366	11,156	27,515	33,787
	1.5%	2.2%	5.9%	13.2%	16.6%
(7) SOUTH AMERICA	5,964	8,807	11,332	12,827	12,845
	2.5%	4.5%	6.0%	6.2%	6.3%
(8) PHILIPPINES	530	544	226	763	881
	0.2%	0.3%	0.1%	0.4%	0.4%
(9) WORLD	235,529	195,233	190,030	208,456	203,229
(Index)	1.00	0.83	0.81	0.89	0.86

Source: Appendix Table 14A.2

Notes:

(1) NAFTA Includes the U.S., Canada and Mexico.
(2) EC includes the U.K., France, Germany, Italy, Spain and the Netherlands.
(3) Asia includes South Korea, Taiwan, ASEAN and China
(4) East Asia includes Japan, South Korea and Taiwan.
(5) ASEAN includes Singapore, Malaysia, Indonesia, Thailand and the Philippines.
(7) Latin America includes Chile, Brazil, Mexico and Argentina.

Table 14.2. Foreign direct investment flows to selected developing countries, 1991

	US$ billion	% of GDCF*
Mexico	4.8	7.4
China	4.4	3.3
Malaysia	3.5	20.5
Argentina	2.4	15.1
Thailand	2.0	5.6
Venezuela	1.9	19.2
Brazil	1.6	2.0
Indonesia	1.5	3.6
South Korea	1.1	1.0
Turkey	0.8	3.9
All Developing Countries	35.9	4.5

Source: *The Economist*, 25 September 1993, p. 15.

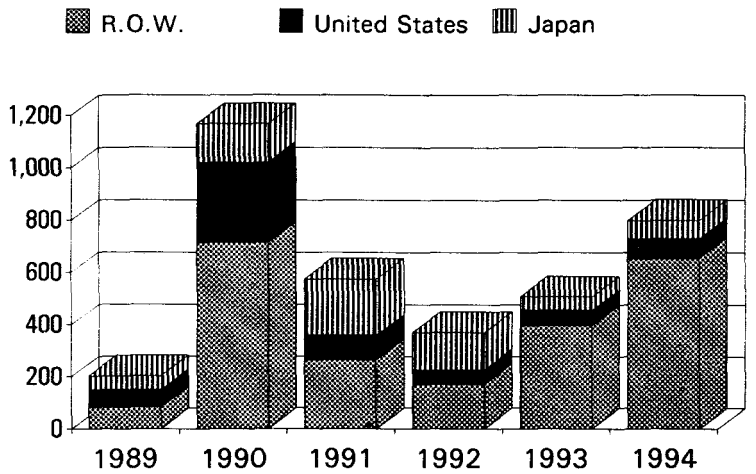
Note: *Gross domestic capital formation

The impact of these flows on the favorite countries of destination has been dramatic. Table 14.2 shows the ratio of FDI to gross domestic capital formation (GDCF) in selected developing countries for 1991. FDIs rose to a fifth of total GDCF of certain countries for that year (Malaysia and Venezuela). The ratio for all LDCs is 4.5 percent of GDCF. Indeed, in many LDCs FDIs account for almost all of the growth being registered. Figure 14.2 shows the rise of FDI since 1989 in the Philippines. This peaked in 1990 ($1,168.7 million), fell in 1991 for reasons already given, and began to recover until it reached $881.34 million in 1994.

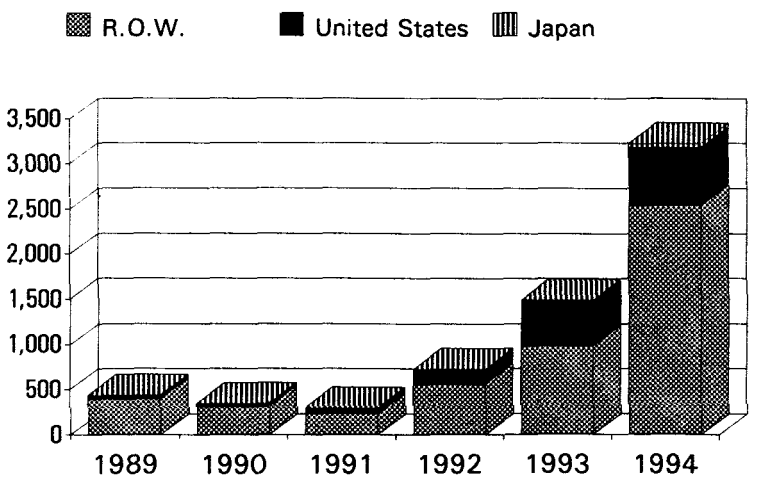
2. *Portfolio Capital*

The buzz words in the financial airwaves are "emerging markets," "arbitrage" and "derivatives." The collapse of Barings and the Daiwa Bank fiasco underscore the pitfalls that await even the most sophisticated in the portfolio speedway. Short-term capital flows in the past were associated with the temporary financing of trade in goods and services and the balancing of accounts to redress disequilibria due to macroeconomic stabilization. This has changed.

Figure 14.2. Foreign direct (FDI) and portfolio investments (FPI) in the Philippines, 1989-1994 (In US$ million)



(a) Foreign Direct Investment



(b) Foreign Portfolio Investment

Source: Appendix Table 14A.3

Innovations in the financial markets in the form of options and derivatives designed to intermediate and diversify purely financial risks associated with cross-border investments have begun to attract major players such as mutual funds into the short-term capital market. The prolonged period of low interest rates in the West in the face of very sizeable interest rates in LDCs—especially those undergoing stabilization—made the switch even more palatable. Furthermore, the gradual liberalization of the capital accounts of many LDCs—whose needs for capital (flighty or otherwise) and the financial market's vote of confidence are considerable—made cross-border capital movements more predictable and speedy. Consequently, short-term capital movement exploded to arbitrage on currency and market mispricing. Suddenly, portfolio flows began to dwarf FDIs. In 1993, portfolio investment into Mexico was $25 billion while FDI was five billion dollars. In the Philippines in 1991, FDI was $881.3 million while portfolio investment was $3.229 *billion*. Of course, by the end of the year almost all of the portfolio inflows had gone and net inflow was almost all FDI. In the process, the stock market and the exchange rate experienced a roller coaster ride.

The volume of resources potentially involved in cross-border short-term capital arbitraging is enormous. In 1989, the clearing house for interbank payments among New York and foreign banks recorded a daily turnover of international payments amounting to $760 billion. Of this about 55 percent was for foreign exchange transactions. Daily currency turnover for April 1989 was estimated by the Bank of International Settlements at one trillion dollars ($1.2 trillion at latest count). This is approximately equal to the combined foreign exchange reserves of all major central banks (Kregel, 1994). The Mexican debacle in 1994 underscores the great danger associated with an unbridled romance with portfolio flows. The Chilean rebuff of portfolio inflows, which mimics the East Asian (minus the Philippines) strategy, reflects its own sad experience with short-term flows in the late 70s (the "Southern Cone Phenomenon") and is credited with insulating Chile from the Mexican tequila effect.

The threat of the portfolio tsunami is very real (we may count New Zealand in 1985-87 and Mexico in 1991-1993 among its victims) especially for countries which, in defiance of the sequencing rule-of-thumb, opened up their capital account prematurely. No one seems to know why the Philippines liberalized its capital account in 1992 given the IMF monetary ceiling, the volatile macroeconomy and the lag of liberalization elsewhere. One view I favor is the "need-to-be-different hypothesis." A liberalized capital account is not among East Asia's list of features. The Philippines lags in infrastructure, labor market stability, governance efficiency, and peace and order. So why not liberalize the capital account? That sets us apart even if we lose one arm!

E. Cross-border Division of Labor in Asia

1. Qualitative Quantum Jump

The globalization of capital in the last decade exhibits not only a quantitative but also and more importantly, a qualitative quantum leap. The Plaza Accord signed in September 1985 engineered the rise of the yen from 240 to about 140 to one US dollar, leading to a massive exodus of Japanese private capital to East Asia. Japanese firms began to unbundle the production process and export manufacturing facilities in the labor-intensive end of production. Displaying macroeconomic stability, Thailand, Malaysia and then Indonesia became the chief destination countries and in no time were transformed into NICs. Japanese multinational companies (MNCs) began locating various stages of a once single production system in diverse country locales to take advantage of each locale's comparative advantages. At the same time, the currencies of the East Asian tigers were beginning to steeply appreciate to reflect their own singular successes and their own political *perestroika* (which allowed a steep rise in wages). Taiwan, Singapore, South Korea and Hongkong began to relocate their facilities and capital elsewhere in Southeast Asia and China. These countries have become visible players in the FDI balance sheet of countries in Asia and elsewhere.

The new dimension in this FDI is that an increasing share of it is decidedly export-oriented. In contrast, FDIs up to 1980 were generally tariff-jumpers seeking to take advantage of rents generated by the protection accorded domestic markets and producers. The massive Japanese investment into the US in the first half of the 80s was motivated by fears of neo-protectionism in the US which was then going through a recession. The Japanese and American investments in the Philippines in the 70s were also tariff-jumpers seeking to exploit the domestic market. The old FDIs reinforced the distortions caused by import substitution. In contrast, the new FDIs adhere increasingly and aggressively to the dictates of the host countries' comparative advantages.

Cross-border division of labor means that Minebea (Miniature Bearings Company of Tokyo) produces 100 percent of its bearings in Thailand, Singapore and China, while Japan holds on to design, research and capital equipment engineering. The bearings are almost wholly exported to Japan and other destinations. Similarly, Panasonic produces floppy disks in Laguna, Philippines which are 100 percent exported. Thus, comparative advantage is reinforced instead of being elbowed out by capital mobility.

2. *The Role of Transnational Corporations (TNCs)*

The new FDIs under the aegis of cross-border division of labor are associated with firms going through the final stage of the Kregel process (Kregel, 1994). The first stage, called "internationalization," involves the expansion of the markets of domestic producers to encompass the world. Thus, local firms export goods to other countries. As foreign markets became important, and the threats of protectionism and regional trading blocs loomed, these firms scrambled to set up foreign subsidiaries. This is the "multinational stage." This is especially true of the automotive industry which has long been protected by nation-states. Production in place was the rage (e.g., the scramble for the US market) while sales remained concentrated in domestic markets of destination countries. Thus, this phenomenon has a trade diversion effect favoring immobile factors of destination countries at the expense of immobile factors of source countries.

The final stage is "transnationalization." To quote Kregel (1994):

The final step in the process of globalization comes as firms consider specific national markets as parts of a single undifferentiated world or global market in which a single product line may be sold. The transnational firm which has become fully global will typically use raw materials and semi-finished goods from producers in a wide range of countries, with the final assembly process decentralized across a number of regional centres producing a unified product, which is then shipped to any and every final market through an integrated global distribution system with an integral sales organization and advertising campaign. In the global firm, primary and semi-manufactured inputs, as well as production and assembly plants, move across country borders just as easily as do the final products.

Thus, in a world populated by global firms there is substantial elasticity of substitution of suppliers of primary and intermediate inputs, which are easily adjusted according to local labor and supply conditions. There is also flexibility in the location of capital investments in productive capacity. To speak of imports and exports in a "global" economy is thus substantially different from the imports and exports of final goods and services which characterize an economy in which firms are simply "internationalized" because the entire production process may move across national borders. Thus, a basic difference in the impact of capital flows in modern times is that they are increasingly the result of the activities of global firms and are part of the process of globalization of their operations.

Since for TNCs market outposts are not the same as production outposts which may be spread across several borders before the finished product is finally assembled, trade in intermediate goods and parts will become more and more crucial. A country may specialize in some automotive parts without the benefit of an auto brand. Taiwan is a case in point. Taiwan targeted the lower C and D markets for replacement auto parts. If you go into an auto parts shop in Manila, you are greeted with the question: "Genuine or Taiwan?" "Genuine" means "Japanese" and costs twice as much as Taiwan-made parts.

F. Cross-border Investment: Origin, Behaviors and Impacts

1. Emerging Features

Japanese transnationals are latecomers to the game, having started in earnest only in the 80s. As already noted, Asia is becoming Japan's post-Plaza Accord manufacturing base (see Table 14.3). Fully half of Japanese FDIs in manufacturing went to Asia in the first quarter of 1995. Since 1994, Asia has surpassed the US as destination of Japanese manufacturing FDIs. Japanese manufacturing industries themselves are becoming more and more dependent on overseas production. Table 14.4 shows the rising production share of overseas production in Japanese, US and German manufacturing from 1985 to 1993. The share for Japanese firms more than doubled from three percent to 7.4 percent in 1993 (but from a rather low base). The US firms rose from 16.6 percent in 1985 to 27.6 percent in 1991 and to 25.2 percent in 1993. For German firms, this share rose from 16.6 to 18.2 percent in 1992.

Japanese firms are also more dependent on their own subsidiaries for imports and as export destinations. Table 14.5 indicates the in-house trade between Japanese parent and overseas subsidiaries. Japanese firms in 1993 imported 37 percent of total imports from subsidiaries but 43.6 percent of their total exports also went to subsidiaries abroad.

The Japanese market has in effect been pried open by Japanese investment and reimports. Copy machines are reimported from Thailand and China. Calculators are reimported from Malaysia and Thailand. Almost all color TV sets in Japan now come from Malaysia. Fax machines are reimported from China and car stereos and floppy disks from the Philippines.

2. Determinants and Trade Impacts

a. FDI Stock

It is interesting to review the determinants of the FDI stock of the US, Japan and Germany, the dominant FDI players. In a cross-country analysis, Hufbauer, Lakdawalla and Malani (1994) examined the response of FDIs to certain indicators of openness {(M+X)/GDP},

Table 14.3. Trends in Japanese direct overseas investment by industry and region (In US$ million, %)

	1990	1991	1992	1993	1994	1995:Q1
(a) Manufacturing:						
U.S.	6,688	5,059	2,784	4,039	4,575	1,897
	43%	41%	28%	36%	33%	29%
Europe	4,196	1,690	2,101	2,041	1,855	583
	27%	14%	21%	18%	13%	9%
Asia	8,068	2,928	3,104	3,659	5,181	3,228
	52%	24%	31%	33%	38%	50%
NIEs	865	640	109	738	647	556
	6%	5%	1%	7%	5%	9%
ASEAN	2,028	1,945	1,808	1,474	2,241	1,223
	13%	16%	18%	13%	16%	19%
China	161	309	650	1,377	1,853	1,364
	1%	3%	6%	12%	13%	21%
Latin America	649	364	267	364	1,159	165
	4%	3%	3%	3%	8%	3%
World	15,486	12,311	10,057	11,131	13,783	6,498
(Index)	1.00	0.79	0.65	0.72	0.89	1.68
(b) Non-Manufacturing:						
U.S.	19,698	12,432	10,023	10,586	12,745	7,929
	48%	43%	42%	43%	47%	53%
Europe	9,132	6,396	4,889	5,885	4,375	1,967
	22%	22%	21%	24%	16%	13%
Asia	3,891	2,891	3,150	2,860	4,232	1,544
	10%	10%	13%	12%	16%	10%
NIEs	2,501	1,507	1,376	1,649	1,918	747
	6%	5%	6%	7%	7%	5%
ASEAN	1,181	1,122	1,382	897	1,505	384
	3%	4%	6%	4%	6%	3%
China	185	230	381	269	808	332
	0.46%	1%	2%	1%	3%	2%
Latin America	2,979	2,973	2,451	3,006	4,072	1,821
	7%	10%	10%	12%	15%	12%
World	40,620	28,809	23,720	24,627	26,877	14,888
(Index)	1.00	0.71	0.58	0.61	0.66	1.47

Source: JETRO compilation from statistics on investment reported to the Japanese Ministry of Finance.

Table 14.4. Trends in share of overseas production by US, German and Japanese manufacturing industries, 1985-1993 (in percent)

	1985	1986	1987	1988	1989	1990	1991	1992	1993
Japan	3.0	3.2	4.0	4.9	5.7	6.4	6.0	6.2	7.4
U.S.	16.6	19.9	22.0	23.9	24.1	26.4	27.6	26.0	25.2
Germany	16.6	15.2	15.6	16.9	18.0	17.9	18.1	18.2	N.A.

Source: JETRO

Table 14.5. In-house trade between Japanese parent firms and overseas subsidiaries (in US$ million,%)

	1991	1992	1993
Exports:			
A. Parent companies' exports	26,962	26,136	28,167
B. Exports to overseas subsidiaries	14,487	11,695	12,291
In-house trade ratio (B/A)	54%	45%	44%
Imports:			
A. Parent companies' imports	10,738	11,083	14,861
B. Imports from overseas subsidiaries	3,178	3,185	5,503
In-house trade ratio (B/A)	30%	29%	37%

Source: JETRO compilation based on "Japanese Companies' Overseas Business Activities," Ministry of Trade and Industry (MITI).

population, per capita income, distance from hub, and region dummies (Asia Pacific, Europe, Western Hemisphere). Appendix Table 14A.4 reproduces their Table 3. In the case of FDI stock, the most important attractors are, as expected, population and per capita income. This is true for all three source countries in three episodes (1980, 1985, 1990). What is interesting is that the openness indicator has a strong positive impact on the FDI stock of Japanese and German FDIs. These two countries are experiencing currency appreciation. This suggests that the currency-appreciating countries direct their FDIs toward economies that are more integrated with the global market. Philippine-bound FDIs of the US whose currency is depreciating are unrelated to degree of openness, suggesting a more domestic market orientation. In other Asian countries like India, US FDIs figure prominently in nontraded goods (e.g., banking, McDonald's, Enron).

b. FDI Flows

The Hufbauer *et al.* (1994) regression estimates on FDI flows are given in Appendix Table 14A.5. It is obvious that FDI flows are more volatile and more difficult to explain (compare the corresponding R^2 of Appendix Table 14A.4 and those of Appendix Table 14A.5). Here, the openness indicator does not figure at all probably because current inflows are realizations of past decisions. The domestic market pull factors are still important for the US and Japanese investments (population and gross domestic product per capita). For Japanese FDIs, investment stock is crucial. A one percent rise in the Japanese FDI stock increases Japanese FDI flows by 0.6 percent. Japanese investors act like Japanese salarymen: where one goes, eveyone goes. This is an interesting consideration in efforts to attract Japanese investments. The state must cultivate one big player (e.g., Minebea in Thailand and NEC in Malaysia) which then passes the word on to others. Matsushita Electric appears to be doing this for the Philippines.

c. Source Country Trade Impacts

As indicated earlier, FDIs tend to change the trade structure of source countries and destination countries. FDIs tend to focus their exports and imports on destination countries. Relevant (Hufbauer *et al.*, 1994) regression results are given in Appendix

Tables 14A.8 to 14A.10. Controlling for host country population, GDP per capita, openness and distance, we see that for the US, Japan and Germany, both exports and imports rise with investment stock. US exports to host countries grow robustly but its imports respond only lukewarmly (statistically speaking). Japan's exports and imports rise robustly with its FDIs. The coefficient of FDI stock on exports ranges from 0.17 to 0.23 while the coefficient on imports is twice as large. Thus, it appears that Japan's FDIs tend to pry open the Japanese market.

The opening up of markets is one of the most important source country impacts. We will argue in Section II.B.3 that the most pronounced impact— worldwide redistribution of rents—is related to market opening and globalization.

II. WHAT'S IN AND WHAT'S OUT IN THE EMERGING WORLD ORDER

A. Import of Technology vs. Import of Firms

1. Nuances in the East Asian Model

The globalization of capital and cross-border division of labor has made possible the emergence of the third tier Asian economic miracles in a much shorter time. Thailand and Malaysia are the prime examples of rapid transition to NIC status under the aegis of foreign investment. China and Indonesia are hot on their heels. But the sources of the rapid growth of these neo-NIC countries contrast with those of the original East Asian model (which guided South Korea and Japan) in one important aspect. The original East Asian model saw indigenous firms importing foreign technology—embodied in new capital or otherwise—and plunging into the difficult process of combining this technology with domestic factors of production. This was done via licensing agreements, reverse engineering and joint ventures. In contrast, the new Asian miracles hastened the process by importing foreign firms. Foreign firms are really a bundle of technologies, marketing and supply networks, organizational expertise, and corporate cultures. In short, the Asian neo-NICs shortened the process of technology acquisition

and adaptation by importing these firms. This way, China exports microwave ovens without going through South Korea's arduous struggle with the magnetron tube, the heart of the microwave oven. In the process, they cede the right over the rents on these technologies to foreign firms. What they get is access to foreign markets such as Japan's, employment with higher incomes for their immobile factors, a restructured export sector and trade balance, not to mention spillover effects to the other sectors of the economy.

Because of this, some observers have labelled the development of Thailand and Malaysia "ersatz capitalism." It is not quite genuine, this view goes, because it is not indigenous; the countries involved do not acquire the firm-level capability to innovate over and advance current technology. Following the endogenous growth theory, these countries have not "endogenized technology" which then limits their growth horizons. This is one view. The other view is that with rapidly rising incomes—Thailand and Malaysia have grown by eight to ten percent per year over ten years—these countries can now afford massive investments in human capital, research centers, and technology and science parks and universities which will nurture new technologies. This strategy says that as long as you get the money and you deploy it properly, you will be able to provide the most basic infrastructure for advances in technology: human capital and research facilities. For the medium-term at least, the import of firms (i.,e., bundled technology) is in and the import of unbundled technology is out.

2. *The Taiwan Model I: From EPZ to Science Parks*

Taiwan appears to have resolved this issue in an eclectic way. Taiwan's Kaohsiung Export Processing Zone started the Export Processing Zone (EPZ) phenomenon in Asia in the 60s. By its very nature, EPZs act as magnets for foreign firms seeking to exploit the country's comparative advantage—in Taiwan's case the then low labor cost and productive work force. South Korea and Japan before that simply closed their doors to foreign firms. There was no Korean counterpart to the long and successful career of the Singer Sewing Machine Company in Taiwan. Matsushita Taiwan which entered in 1962 as a labor-intensive manufacturer has evolved into one of the backbones of Taiwan's information technology industry. Having ridden the Free Trade Zone (FTZ) and labor-intensive light-

manufacturing horse with singular success, the question for Taiwan then was: Where to from here? South Korea had the Daewoos and Hyundais to finance in-house R & D to nurture innovation. Technical change (also known as total factor productivity) which figures more and more as the dominant source of economic growth among mature economies, appeared to be more internally feasible under South Korea's *chaebols* than under Taiwan's multitude of smallish firms. For a while, the weight of opinion was that Taiwan's growth horizon was shorter than South Korea's because of the latter's larger capacity to endogenize technological progress.

But with growing affluence, over $100 billion in foreign exchange and the authorities' recognition of the central importance of technology, the Taiwan government moved from EPZs to "research institutes" and "intelligent industrial parks." Among these are:

a. The Hsinchu Science Industrial Park (HSIP). Established in 1980, HSIP is tailored to high-tech industry and is run by the National Science Council. In its vicinity are two national universities and an industrial technology research institute. It has attracted some of the most aggressive and "intelligent" companies in the world, *viz.*, Macronix International Co. Ltd. (wafer fab), Taiwan Semiconductor Mfg. Co. Ltd. (very large-scale integrated circuits or VLSI wafer), Texas Instruments-ACER, INC. (4 Mb dynamic random access memory or DRAM and 16 Mb DRAM), UMAX DATA Systems, Inc. (optical scanners, software), and Winbond Electronics Corporation (integrated circuits or ICs). HSIP now has 170 firms under its wing, with integrated circuits makers the most numerous (51) and personal computer or PC makers coming in second with 39. On board are 36,000 employees.

Another science park is located in Tainan. Within the next ten years, 20 to 30 other intelligent parks will be developed, according to the Asia Pacific Regional Operations Center (APROC) Plan which aims to make Taiwan an "intelligent" manufacturing center. Likewise, in recognition of the other requirements of the information revolution, Software Parks will be developed in the Taipei, Taichung and Kaohsiung areas.

b. The Industrial Technology Research Institute (ITRI) was founded in 1973 as an R & D organization engaged in applied research. Its R & D work on ICs spun off a company manufacturing submicron ICs using eight-inch wafers in 1994. Microfiber technology breakthroughs have rejuvenated and pushed the textile industry into higher value-added activities. It has obtained 368 patents of which 170 are foreign, and has transferred over 450 technology items to private companies.

c. The Institute of Information Industry spearheads the identification and acquisition of emerging frontier technologies and initiates their commercial adaptation. It is the technology espionage and snooping agency.

3. The Taiwan Model II: Joint Ventures and High Tech TNCs

The nucleus of Taiwan's "intelligent industry" is a mixed bag of indigenous start-ups, joint ventures and transnationals on the leading edge of the technological frontier. Some of these are:

a. Texas Instrument-ACER, a joint venture between Stan Shih's and Taiwan's wonder firm and one of the world's leading chipmakers.

b. Taiwan Semiconductor Mfg. Co. Ltd., a joint venture between Taiwan and Phillips Electronics, N.V. It manufactures VLSI wafers.

c. World Wiser Electronics, Inc. which started manufacturing printed circuit boards in 1970. It operates with a long list of OEM partners (e.g., Apple, Fujitsu, Hitachi).

d. Matsushita Taiwan which has 23 factories producing 50 products, including automation equipment.

e. Philips Taiwan, which was one of the first tenants of Kaohsiung EPZ. It has transformed itself into an intelligence-intensive company.

4. Philips Taiwan: The Evolution of a TNC

Philips entered Taiwan's Kaohsiung EPZ in 1966 in order to take advantage of low labor cost for labor-intensive memory boards. Thus, it resembled the multitude of firms that today flock to PRC, Indonesia, Thailand and the Philippines. Philips Taiwan has since transformed itself into an intelligent firm manufacturing monitors, cathode ray tubes and ICs. Its computer monitor plant is now a Philips global competence center. Cooperating with ITRI, it has the best record of technology transfer for surface mounted technology, opto-electronic components and technology for CD audio and CD-ROM. It won the Deming Medal for quality control in 1991 and devotes six percent of revenues to R & D.

The transformation of Philips Taiwan over the last 30 years is remarkable as it moved from labor-intensive manufacture in 1965-1975 to capital-intensive manufactures in 1976-1990, and finally to intelligence-intensive manufactures in the 90s. Philips Taiwan vindicates the belief that TNC subsidiaries can evolve and, in a proper environment, upgrade to higher value-added products benefitting from both the advances of the mother company and synergy with local firms.

Taiwan's middle-course approach seems to be the most attractive for other LDCs. How did this come about? Taiwan acquired core industrial competence in labor-intensive light manufactures and, with it, the financial clout to upgrade. It now spends $4.9 billion in R & D or about two percent of GNP, up from 0.98% in 1986. But Taiwan's greatest asset remains its highly skilled labor force and its world-class infrastructure (a result of two 10-year major projects financed by its bulging foreign exchange reserves). This strategy has not changed. Taiwan is now building the National Information Infrastructure (NII) whose skeletal hardware is a broadband high-speed network with optical fiber cable. It will integrate informationally every aspect of Taiwan's economy. Today Taiwan leads the world in mice and scanners; ranks second in the world in terminals and network interface cards; ranks third in the PC market; and ranks fifth in ICs. In terms of number of patents granted by the US, Taiwan ranks eighth in the world. (Sections A.2. to A.4. owe a lot to *Scientific American*, October 1995).

Because Taiwan is its closest neighbor besides PRC, the Philippines must have a properly thought out "Taiwan posture."

B. Trade Theory

1. Is "Comparative Advantage" passé?

This seems to be the message implied by the new "competitive advantage" viewpoint (see, for example, Thurow, 1992; Warr, 1994; de Dios, 1995). The "competitive advantage" view is that with factor mobility (*viz.*, capital mobility) the law of comparative advantage no longer holds (Thurow, 1993). This is only partly correct. The "law of comparative advantage" says that a country does best if it concentrates on certain commodities where its cost edge is greatest even if it has absolute edge on all commodities. Though obvious, this is the object of a lot of confusion and misunderstanding. Comparative advantage has nothing to do with factor mobility. If factors move, then a country may find itself having the largest cost edge in another set of commodities. It will do best in this new set, as the law claims (see also School Brief, *The Economist*, Jan 29-Feb 6, 1996).

However, there is a specific textbook model of trade that has become partly *passé*. This is the two-good, two-factor, two-country model of trade in the Heckscher-Ohlin tradition (also called "factor proportions theory") which says that a country will tend to export (i.e., will have a comparative advantage in) the commodity intensive in the use of its relatively abundant factor under a number of strong assumptions, one of which is that factors are nontraded. I call this the "basement Heckscher-Ohlin (H-O) model." Under the basement H-O model, trade in factors is a substitute for trade in goods (see B.2. below). Direct foreign investment is therefore trade-reducing. This indeed may have been the case in many protectionist LDCs before the 1980s. Tariff-jumping FDIs tended to substitute for exports from home countries and tended to be immiserizing. FDIs then tended to reinforce the distortions of import substitution and to raise their welfare costs. This was the very neoclassical proposition of Brecher and Diaz-Alejandro (see B.3. below). But the movement of latter-day cross-border division of labor FDIs is motivated precisely by changing comparative advantage (a rise in domestic currencies and thus of wages, i.e., the relatively higher

cost of immobile factors at home) and is increasingly export-oriented. Firms now cross borders in search of the best cost configuration and thus emphasize comparative advantage.

The emerging cross-border division of labor and the enhancement of trade in goods mediated by FDIs suggest that the basement H-O model is no longer entirely appropriate because the occurrence of trade is no longer due wholly to given factor proportions. Still, everyone taking trade theory knows that the basement H-O model is really just a platform for building more realistic and complete models of trade. Capital mobility at the turn of the century reveals the incompleteness of the basement H-O model even as it highlights the law of comparative advantage.

2. Kemp-Jones Model

The Kemp-Jones model (Kemp, 1966; Jones, 1967; Mundell, 1957; Ruffin, 1984) extends the H-O model to differential technology and capital mobility. Our immediate concern, of course, is the emerging empirical complementarity between trade in goods and trade in capital which has quietly become the dominant pattern.

Suppose two countries—Home and Foreign—are identical in everything (factor endowment, homothetic technology, homothetic taste) with the usual competitive internal markets. No trade will come about if the two are opened to trade in goods and factors since the domestic price ratios are identical.

a. Suppose Home experiences a rise in capital endowment and then following the Rybczynski theorem, the output of X (the capital-intensive good) rises while the output of Y (the labor-intensive good) falls at constant prices. With homothetic taste, the price of X will fall and the domestic terms of trade induces the export of X and the import of Y if trade in goods is allowed but not trade in factors. However, one must note that the divergence between the Home terms of trade and that of Foreign implies a divergence in the wage-rental ratio. This is given by:

$$|\lambda| \ (\hat{r} - \hat{w}) = (\hat{P}_x - \hat{P}_y),$$

And the famous Stolper-Samuelson proposition, i.e.,

$$\hat{P}_x < \hat{P}_y <=> (\hat{r} < \hat{w})$$

Now, if trade in one factor, capital, is also allowed, capital flows out of Home to Foreign (because the wage-rental ratio is lower in Foreign or the price of capital is higher there). Following Rybczynski, the output of the capital-intensive goods falls at Home (export of X falls) and the output of labor-intensive goods in Foreign falls (export of Y falls). Thus, capital mobility is a substitute for trade in goods. This is the basement Heckscher-Ohlin model prediction first discussed in Mundell (1957).

b. Now suppose we go back to the original identical autarkic positions. Instead of an endowment change, let Home experience technical progress which gives it a comparative advantage in X, the capital-intensive good. The price of X falls relative to Y and, with goods trade but not trade in capital K, X will be exported by Home. But the aggregate marginal product of capital rises (see Ruffin, 1984, for a simple demonstration) since technical progress has occurred in the capital-intensive good X. So Home interest rate (r) is greater than the foreign interest rate (r^*) and capital flows into Home which, following Rybczynski, raises the output of X (and its export). Thus, capital mobility reinforces trade in goods. This is the Kemp-Jones model result which predicts the now dominant pattern in modern world trade.

3. *Brecher-Diaz-Alejandro Welfare Proposition*

In the 1960s, the Philippines and many other LDCs had a jaundiced attitude toward FDIs. Numerous legislations in the past were designed to regulate rather than to attract FDIs. Although this was motivated by nationalist sentiments and fear of superpower influence (mainly US influence), the world economic environment was then also very protectionist and FDIs were largely tariff-jumpers. In this environment, the possibility of FDIs reinforcing host country distortions was very pronounced and therefore welfare-reducing. Since the highest rents are generated in the most protected areas, FDIs in those areas can produce goods with negative value-added at world prices. This is the Brecher-Diaz-Alejandro Proposition (Brecher and Diaz-Alejandro, 1977).

The nationalist myopia that created the protectionist phalanx made suspicion of FDIs only logical. Indeed, studies of FDI impacts across countries seem to show this. Fry (1994) studied the impact of FDIs on several important indices—*viz.*, per capita income growth, investment ratio, exports and import ratios—and found some surprising dichotomies. His results are given in Table 14.6. For East Asia, FDIs have positively and robustly influenced these variables, suggesting that East Asia benefitted from FDIs. On the other hand, in the case of Latin American countries, the responses of these variables to FDIs were either negative or insignificant. This suggests that the capacity of the host country to benefit from FDIs depends on the host country's trade regime. Export orientation attracts the beneficial FDIs; import substitution attracts rent-seeking FDIs. Swans attract swans; carrion attracts maggots. Even the World Bank Development Report of 1991 acknowledges that in a distorted economy FDI can take out more than it can bring into the host country.

An aggressively liberalizing world has less room for rent-seeking FDIs. The WTO favors welfare-improving FDIs. The golden age of the negative Brecher-Diaz-Alejandro proposition is hopefully at an end. Thus, the trade liberalizing policy of the government is very economically sound in view of cross-border capital flows.

4. *Von Thunen Redux*

J.H. von Thunen (1783-1850) is considered the founder of "location theory" which recognizes space as an ingredient in economic analysis. In this analysis, there are two types of factors of production: mobile factors (capital) and immobile factors (land, unskilled labor, basic services). If owners of mobile and immobile factors are profit maximizers, what spatial patterns will emerge relative to a central market?

Mobile factors such as capital obey the law of one price everywhere. Immobile factors have the highest price near the center and this declines the farther away one moves. This means that immobile factors absorb the cost of "space bridging." As transport cost falls, the difference in returns to immobile factors also falls. Better roads, ports and other inirastructure lower the advantage of nearness to the center. Also, lower tariffs and trade barriers help

Table 14.6. Long-term effects of foreign direct investment: East Asian vs. non-East Asian Economies (1972-1992)

6 East Asian* Economies	11 Non-East Asian** Economies	
$\frac{I}{Y}$ rises with $\frac{FDI}{Y}$	$\frac{I}{Y}$ falls with $\frac{FDI}{Y}$	(1)
$\frac{S}{Y}$ rises with $\frac{FDI}{Y}$	$\frac{S}{Y}$ falls with $\frac{FDI}{Y}$	(2)
$\frac{X}{Y}$ rises with $\left(\frac{FDI}{Y}\right)_{5\text{ - year ave.}}$	$\frac{X}{Y}$ falls with $\left(\frac{FDI}{Y}\right)_{5\text{ - year ave.}}$	(3)
$\frac{\Delta Y}{Y}$ rises with FDI	$\frac{\Delta Y}{Y}$ falls with FDI	(4)

Source: Maxwell Fry (1994)

Notes:

* East Asia includes: Indonesia, South Korea, Malaysia, Philippines, Singapore and Thailand.

** Non-East Asia includes: Argentina, Brazil, Chile and Mexico (Latin America); India, Pakistan and Sri-Lanka (S. Asia); Nigeria (Africa); Turkey and Egypt (Near East).

the periphery compete (hence the importance of WTO). Production near the center will use more mobile capital; production in the periphery will use more of the cheaper immobile factors. Since locating to distant shores is risky, risk-reducing measures (for example, economic and political stability) are also helpful. Predictable and stable institutions of law and contracts reduce "transactions cost" and reduce risk. An adequate information infrastructure is also welcome. Moreover, a skilled labor force raises productivity and attracts mobile factors. (See Kasper, 1994 for an excellent discussion.)

Eventually, new centers develop as some nodes in the periphery become affluent. (The world market is now essentially tripolar: USA, EU, and Japan-NIEs.)

The lesson from location theory is that the burden of attracting mobile factors falls squarely on immobile factors at some distance from the center. The periphery must offer a package of immobile services that make mobile factors very productive. Ultimately, the competitiveness of each location resides in the attractiveness of the package of immobile services it offers. Because the set of immobile services is varied and its elements are subject to improvement, there is considerable latitude for competition.

5. Other Capital Flows

In a WTO-nurtured world, the previous conduits for capital flows to LDCs—direct state foreign borrowing and foreign aid—are no longer crucial nor favored. First, state or quasi-state foreign borrowing from the world private financial market was the foundation stone of the "lost decade" (the debt crisis decade of 1980s). This is especially true of the Philippines and Latin America. Instead of financing capacity to pay, state or quasi-state foreign borrowing financed rent gravy trains. Foreign borrowing by private agents is still kosher. In the world of cross-border division of labor, mounting foreign debt especially from private commercial banks is a disincentive for FDIs. The case of the Philippines which began to attract FDIs in droves after the debt service fell below 20 percent is very telling. In other words, direct foreign borrowing may have a net negative resource impact beyond a certain point.

There is a noisy debate about the prospects of foreign aid and much pessimism about its benefits. In the new world order, "Trade not Aid" is the slogan of the more advanced developing countries. Aid is so much more a political instrument. It can be withheld to punish or increased to reward favored political actuations. And with the decline of superpower confrontation, even the source countries are becoming uninterested in giving aid (either because they can no longer afford it absolutely, like Russia and Cuba, or because of deficit-cutting imperatives as in the case of the US).

Even if at a lower level, foreign aid will remain with us. However, we feel (in agreement with the emerging Organization of Economic Cooperation and Development Fund or OECF view) that foreign aid must reconcentrate on physical infrastructure.

This is very much in keeping with the imperatives of cross-border division of labor: the urgent need to "attractivize" the domestic immobile factors and to facilitate cross-border equity investment as a whole.

III. COMPETITIVENESS

In a world governed by the WTO and cross-border division of labor, what are the parameters of competitiveness? We claim that country competitiveness will more and more be fought in the field of "soft and hard infrastructure."

A. Where We Stand: WCR

The *World Competitiveness Report* (WCR) defines "competitiveness" as "a country's ability to create and sustain economic value-added in the long term, relative to its competitors." The WCR "Executive Opinion Survey" ranks countries on eight "factors of competitiveness," given in Appendix Table 14A.5.

These factors encompass 330 criteria. The interesting aspect of this list of factors (capabilities) is the preponderance of the nontraded sectors (Factor II to Factor VIII). These are the factors (immobile factors in trade theory) with which mobile capital combines to produce value-added. "Domestic economic strength" (Factor I) mimics GDP per capita in the Hufbauer *et al.* study. "Internationalization" (Factor II) mimics the "openness indicator" in Hufbauer *et al.* In the era of cross-border division of labor, the most crucial among the nontraded factors for LDCs are Government and Government policies (governance or soft infrastructure), Infrastructure (hard physical infrastructure) and Human Capital (Science and Technology as embodied in people). Transnational firms carry their own capabilities in Finance and Management and disembodied technology.

In the interest of brevity, we will refer to physical infrastructure as "hard infrastructure" and Governance, Policies and Human Capital as "soft infrastructure."

For all it is worth, and despite our own reservations about its adequacy, the results of the 1992 survey are given below (Appendix Table 14A.6). In 1992, the Philippines' overall ranking was 33rd among 41 countries. It stood below all the Southeast and East Asian countries (as expected). Its worst showing was in Infrastructure (39). It got less than median ranking in Government (29), Science and Technology (34), and People (36—a surprise since the country prides itself in its educated work force). Among the 18 non-OECD countries, the Philippines again fell below median at rank 12 and below all the Asian countries except India. Three former Iron Curtain countries (the Czech Republic,Hungary and Poland) fell below the Philippines but this was in 1992, only two years after the collapse of the Iron Curtain. These countries have moved up since. Overall, in the eyes of business executives the Philippines is among the worst (bottom quintile) among the 41 countries and middling (middle 30 percent) among the 18 non-OECD countries. But also, the Philippines was just emerging from a recession and still had to implement Executive Order (EO) 470 and EO 8. Thus, we may expect that the Philippines will have risen in the esteem of business executives, although recent reports are not encouraging.

B. Where We Stand: JETRO Survey

More immediately important because of its crucial influence in firm decisions about where to locate FDIs in Asia are the results of a Japan External Trade Organization (JETRO) survey of Japanese firms in 1995, regarding major manufacturing-related costs. Table 14.7 reproduces the results. The monthly wages in the Philippines (US $160-220) is higher than Indonesia's ($100-200) and China's ($66-130). With the exception of Japan, the Philippines has the highest rate per kilowatt hour of industrial power (11 cents). Table 14.8 gives distribution-related costs. The Philippines has the highest truck freight rate ($75), after Japan ($100). It also has the lowest customs clearance fee ($14), although this has to be clarified. The low legal fees attributed to the Philippines does not reflect the total

Table 14.7. Major manufacturing related costs in selected East Asian cities and Japan (in US $)

	Singapore	Bangkok	K.Lumpur	Jakarta	Manila	Shanghai	Japan*
Wages (monthly)	630-1,150	160-310	190-290	100-200	160-220	66-130	3,216
Industrial land (per sq. m.)		82.5	85-128	60-66			370
Power (per KWH)	0.07	0.04	0.06	0.035-0.074	0.11	0.07	0.13

Source:
JETRO compilations based on "Comparison of Investment-related costs in Major Cities and Regions" (September 1995, JETRO); "Survey on Actual Conditions of Salaries by Occupation in the Private Sector (National Personnel Authority); "List of Lands Suitable for Plant Construction" (MITI), and various oral surveys. Figures for East Asia were provided by several local Japanese affiliates.

Note: *National average.

Table 14.8. Index* of distribution-related costs, Japan *vis-á-vis* selected Asian countries, 1995

	Japan	Korea	Taiwan	H.K.	S'pore	Malay	Phils
(1) Truck freight	100	63	46		54	45	75
(2) Customs clearance (customs service agents)	100	24	48	"(7)	"'20 (26)	25	14
(3) Marine freight	"""100	109	89	92	102	98	103

Source: JETRO compilation based on various oral surveys (as of October 1995).

Notes:

* Figures are relative to Japan's benchmark (100)

(1) Freight per 100 km.

(2) Fee for warehouse-to-container yard delivery.

(3) Freight using a regular container liner from Hakata, Pusan, Chilung, Hong Kong, Singapore, Penang or Manila to Los Angeles.

"Customs service agents are not used in Hong Kong. The figure in the parentheses indicate the customs clearance fee when the container is delivered to Hong Kong via Shumchuh (China).

"' The figure in parentheses indicates the freight charge when the container is delivered to Singapore via Batam Island (Indonesia).

"""Freight per 20 foot-container of finished products (computers).

fee (i.e., legal plus illegal plus turnaround time). The Philippines has the second highest marine freight ($103) after Japan and South Korea but this is partly due to the fact that return trip occupancy is very low.

These results show a grim picture of our relative standing *vis-á-vis* our immediate rivals for Japanese investment. However, there has been a shift in the perception of the Philippines as a destination among Japanese firms probably because of the souring of initial enthusiasm over PRC and Vietnam. Still, our share of Japanese investment remains very small.

C. Information Technology and Infrastructure

1. Cable TV and Global Information

The Philippines is experiencing some of the developments brought about by the information revolution. Satellite communication and cable distribution now allow access to CNN and BBC at affordable prices even in remote towns. The immediate result is that the information monopoly of Metro Manila is being rapidly undermined as small towns tune in to global networks. But the programming menu of these cable services leaves a lot to be desired. At least two of the ten channels usually on offer should be the "BBC" and "Discovery Channel" so that teachers and students in remote towns can participate in the ongoing global scientific and technological dialogue.

2. Comparative Information Infrastructure

Despite the considerable gains in telecommunications deregulation, the Philippines suffers in comparison with its neighbors except China (see Table 14.9). Although dated (1991) the relative ranking hasn't changed much simply because our neighbors have been rapidly moving forward. In 1991, teledensity was only 1.03 mainlines per 100 population (1.04 in 1994) and 85 percent of this was in Metro Manila with two-thirds of the country's towns still unserved. The number of mobile phones per 1,000 population was 0.5, better than in Indonesia or China (though one must remember that China is a large country and the PRC that competes directly with East Asia consists only of the littoral provinces which have a much better profile). But mainline conversion to digital telephony is lowest in the Philippines (23 percent) and Indonesia has more televisions sets per 100 population (5.7 vs. 4.2).

Deregulation has roused a somnolent industry and mobile phones are linking more and more people and places while mocking the slow response of fixed-linked wire communication. Further progress in fixed or linked infrastructure is being stymied by coordination problems. Moreover, the fixed-linked telecoms issue

Table 14.9. Telecommunications access across selected Asian countries, 1991

	Fixed lines per 100 Pop'n	Mobile phones per 1,000 Pop'n	Digital Exchange(%)	TV receivers per 100 Pop'n
China	0.73	0.0	18	2.7
Indonesia	0.68	0.1	50	5.7
Korea	11.68	3.8	92	20.0
Malaysia	9.91	3.3	78	14.8
Philippines	1.01	0.5	21	4.2
Singapore	19.85	19.0	71	37.2

Source: Lamberton (1994)

is lying idle in the Supreme Court. This delay can, in fact, facilitate alternatives to fixed-linked infrastructure such as personal communication service or PCS (Lamberton, 1994).

Information infrastructure is now very important for two reasons. First, it is becoming a basic need for foreign investors, especially those who invest in order to export. Secondly, the upgrading of human capital and education will lag behind without adequate information infrastructure (e.g., Internet connection). In the Information Age, wireless and satellite communications will become more and more the leapfrogging technology.

The information industry is one of the world's most vigorous. Some niches in this can be exploited. For example, modems and fax machines are now produced mostly in LDCs (in China with Japanese FDIs). The Philippine government can pay special attention to this.

D. "Competitiveness" Revisited: A Von Thunen View

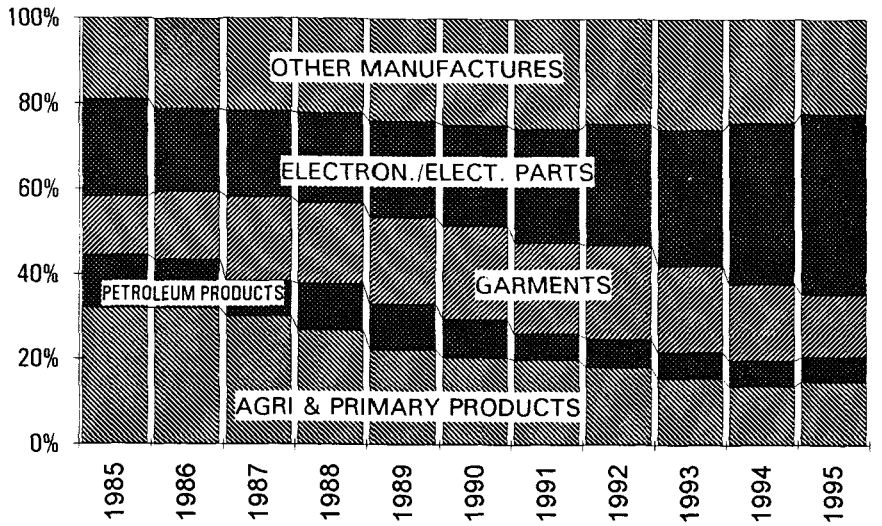
Whether gleaned from WCR or the JETRO Survey, it is clear that the intuition behind the controversial term "competitiveness" (in the "competitive advantage debate") resides in the attractiveness (*a priori*, the productivity-cost configuration) of the immobile factors. This is the Von Thunen view. Krugman (1994) objects to the phrase "national competitiveness" because he believes competitiveness resides in firms, not in nations. On the other hand, the proponents of national competitiveness (Porter, 1990) appear to view nations as firms with a menu of capabilities. Echoes of "Japan, Inc." and "Korea, Inc." The Von Thunen is that competitiveness resides in the nation's immobile factors. It resides in its capacity to attract mobile factors. Thus "national competitiveness" is meaningful but in a surprising arena: capital mobility. Now country ads are clogging the global TV networks and print media are extolling the business climates of individual countries (Israel in CNN; Taiwan in *Scientific American*). The Von Thunen concept of competitiveness is very much in keeping with the view expressed by Jones and Neary (1984) in their oft-cited survey:

> *However, once factors of production are mobile internationally, such inter-country differences can assume major importance in determining where factors of production choose to be employed. The doctrine of comparative advantage then yields in some respects to the doctrine of relative attractiveness, the relative capacity of countries to attract internationally footloose productive factors.*

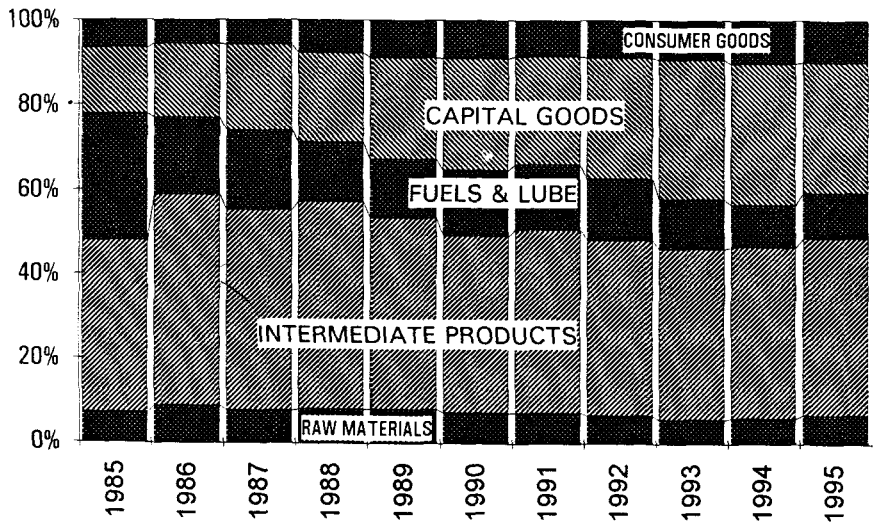
IV. IMPACTS ON THE PHILIPPINE ECONOMY

We will explore the impact of the FDIs reflected in Figure 14.2 (see p. 433, above) and of cross-border division of labor on the Philippine economy at two levels: (i) the structure of foreign trade and (ii) the emerging destination of trade. It is shown in Fabella and Paderanga (1996) that FDIs in the Philippines concentrate on certain areas, *viz.*, Microcircuits and Electric Machinery. How have these affected export and import shares and trade with source countries?

Figure 14.3. Distribution of Philippine exports and imports by major commodity group, 1984-1995 (in percent)



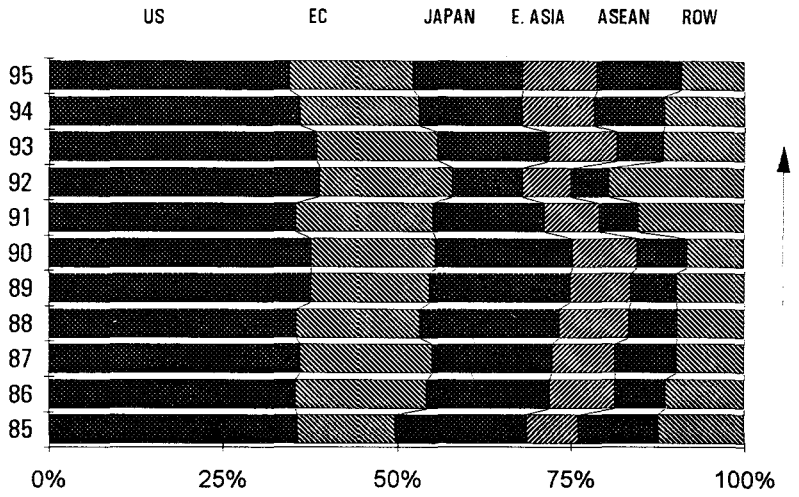
(a) Exports



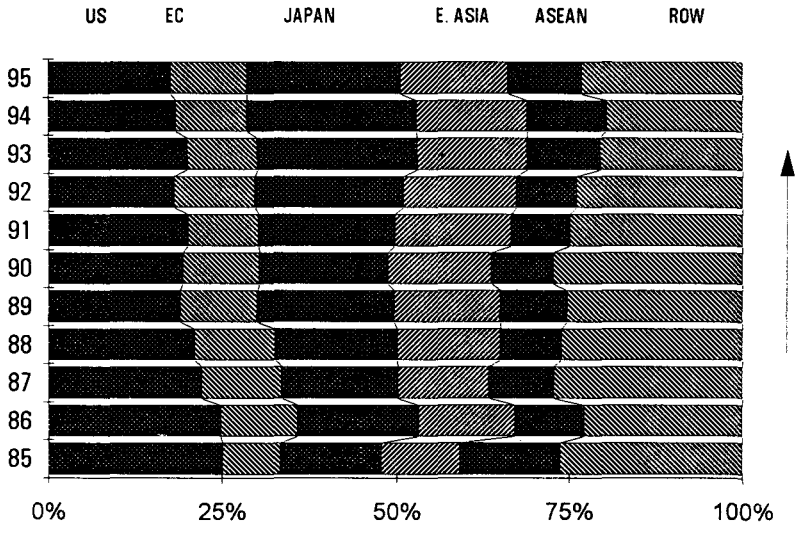
(b) Imports

Source: Appendix Table 14A.7

Figure 14.4. Direction of Philippine foreign trade by major country/region (in percent)



(a) Exports destinations



(b) Imports sources

Source: Table 14A.8

A. Export Structure

The impact of currency realignment *cum* cross-border division of labor on Philippine exports is dramatic. Figure 14.3 indicates the shares of major commodity groups on Exports. The exports of manufactures grew from 54.8 percent in 1985 to 70 percent in 1990. It then rose further to 78 percent in the first semester of 1995. All other export commodity groups lost out. This 23 percent gain in the share of manufactured exports, however, came mostly from one item—Electrical and Electrical Equipment/Parts and Telecoms, whose share in the total rose from 23 percent in 1985 to 41 percent in 1995, accounting for a gain of 18 percent. Garments, the other big export, lost eight percent from 1992 (22 percent) to 1995 (14.4 percent). Thus, the impact of foreign investment on the structure of exports has been very dramatic.

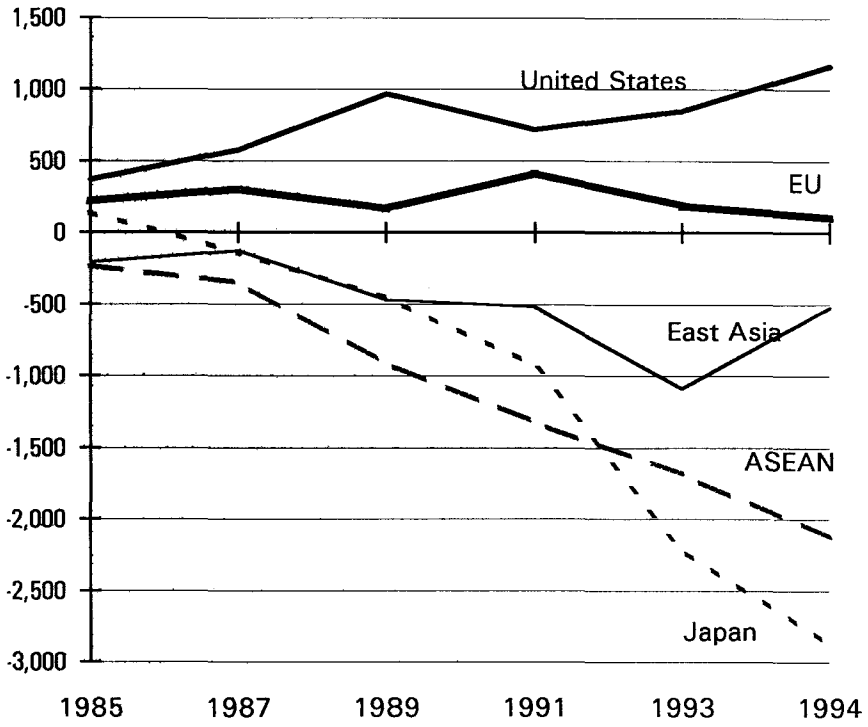
B. Import Structure

Figure 14.4 shows the evolution of the import structure from 1985 to 1995. The major gainer is clearly Capital Goods whose share of 15 percent in 1985 rose to 32.3 percent in 1994. This is clearly affected by foreign investors whose investments come in the form of capital goods imports. In this decade, Semi-Processed Raw Materials accounted for the largest share of imports (between 39 percent and 47 percent). The share of consumer goods is also rising as a result of trade liberalization and the strong peso.

C. Export Destination

Figure 14.5 indicates the share of export destination countries. The US is the principal destination but its share receded to 34.5 percent in 1995 from a high of 38 percent in 1990. The European Community (EC) holds its own with a slight increase (from 14.02 percent to 17.7 percent in 1995). Japan's share of exports fluctuates between 14 percent and 20 percent but on the whole it has fallen slightly since 1989 (from 20.28 percent to 16 percent). Since 1991, the share of exports to Hongkong, South Korea, Singapore, Indonesia, Malaysia and Thailand has also increased.

Figure 14.5. Balance of trade, Philippines vs. major countries/ regions (in US$ million)



Source: Table 14A.10(c)

D. Imports Source

Figure 14.5 also shows the origin of Philippine imports. The US share fell seven percent (25.08 percent to 17.66 percent) in the ten years from 1985 to 1995. The EC raised its share by about two percent in the same period. Japan's share rose dramatically by 10 percent from 14.3 percent in 1985 to 24.5 percent in 1994. In 1994, Hongkong, South Korea, Singapore, and Taiwan all gained. All these are consistent with cross-border division of labor motivated by currency realignments during the period.

E. Trade Deficit Structure

The structure of the Philippine trade deficit is expected to shift toward countries which have increased their (foreign investment) stake in the Philippines, as shown in Figure 14.5. This is expected as FDIs motivate imports of capital and semi-processed imports from source countries. The trade deficit with Japan has risen dramatically and may reach 50 percent of the total trade deficit. Meanwhile, there is some indication of an increase in the trade surplus with the USA since 1991. The trade deficits with the Asian tigers (Hongkong, Singapore, Taiwan and South Korea) are also all on the upswing. While the Philippines still enjoys a trade surplus with Thailand, the deficits with Indonesia and Malaysia are on the rise.

V. A QUESTION OF POLICY: WHAT'S TO BE DONE?

These developments have implications for policy and growth strategy.

A. Micro Upgrading Vs. Infra and Business Environment Upgrading

In order to grow and sustain growth, the economy must nurture firms that are technologically nimble and up to speed. That hardly describes the Philippine economy today. This is why well-meaning observers suggest the need to technically upgrade Filipino firms. Incentives for upgrading should be provided as this will involve the acquisition of new equipment. This, for example, appears to be the mandate of the Asian Productivity Organization (APO).

The experience of Taiwan suggests another path: *upgrade the general economic environment.* This has two components: (i) macroeconomic stability, and (ii) the provision of a competitive infrastructure. Once these conditions are met, firms on the technological frontier will come and operate. Within a liberalized environment, existing firms will on their own upgrade their facilities or go bankrupt. One need not waste the government's limited resources on identifying and targetting so-called "winners" among industries and firms.

Infrastructure provision has several dimensions. One is soft infrastructure in the form of stable and predictable governance. This includes peace and order and security, all of which which are vital. This is where Singapore, for example, is a world beater (number one in the WCR index). Equally important is hard infrastructure in the form of roads, ports, telecommunications, shipping and the like. The third dimension is human infrastructure or skilled and educated labor in a predictable and stable labor market (again Singapore is number one here).

Unfortunately, the Philippines is very deficient in the provision of soft and hard infrastructure (rank 39th out of 41 in the 1992 WCR). Deregulation in shipping and telecoms is showing a promising harvest but the improvement is relative to our own past and not to the standards in East Asia. Our East Asian neighbours are upgrading even faster. Despite our edge in English (which is fast being eroded), human capital is another area of lost ground. Our educational system celebrates "soft knowledge" as much as it cringes from "hard knowledge" (science, engineering, mathematics). "Soft heads" are a real threat to long-term growth.

The upgrading of infrastructure will require a lot of resources (despite BOT), in addition to a tax reform and improved government revenue collection. It is in these areas that government is most productive as a handmaiden of industry and private enterprise and as a foster parent of economic growth.

B. Tripartism: The German Model

Surviving and winning in the global market requires more and more cooperation among the major players in the domestic economy, namely, government, labor and management. In the past, with closed markets and monopoly positions, an adversarial posture between these players was an affordable luxury. Conflicts over the distribution of the economic pie between labor and management were often resolved by forcing the hapless consumer to pick up the tab. In an open economy, this is no longer possible. Costly industrial disputes only allow foreign goods entry and perhaps a permanent foothold. If labor and management cannot get their act together, they will both starve, as US carmakers and unions in Detroit learned

the hard way. In other words, the fallback positions of parties in dispute have dwindled. This is where German Tripartism deserves emulation.

To address the problem of unemployment in Germany without upsetting the macroeconomic balance and losing world competitiveness, German government, business and labor unions met in a conference where Claus Swickel, the new head of the most powerful union in Germany, IG Metall, pledged not to ask for any wage increase in the next three years in exchange for 400,000 new hires. This is a paradigm shift in IG Metall's history that is eminently consistent with the global imperatives. Because of high labor cost in Germany, German investment has been moving to East Europe and elsewhere, creating unemployment at home and shrinking the membership of IG Metall. Wage increases only make for very prosperous but fewer and fewer workers and eventually lead to a loss of union power and irrelevance. The "Klaus Swickel doctrine" is one that organized labor in the Philippines must begin to notice. In the global market, cooperation is not a luxury but a survival imperative. Of course, the cooperative attitude in Germany contrasts very starkly with the confrontational posture in France as shown in *l'affair Juppe*. However, whether in France, Germany or Japan, cross-border division of labor and capital globalization are shaking long-held beliefs and whittling down once sacrosanct entitlements as trade in both goods and factors fulfill their primary mission of redistributing rents. Whether a fair share of the redistributed rents will fall on the Philippines depends only on ourselves.

C. The "Poor Country Card"

In the WTO-governed world, poor countries will still have elbow room. Such is the power of indigence. Poor countries will be allowed some bending of the rules. This is why PRC adamantly wanted to join the WTO as a "poor country." The US opposed this. But the Philippines is a trade deficit country and trade imbalance is one valid reason for adjustments. Beggar-thy-neighbour currency devaluation is generally overlooked for this type of economy but is considered predatory when done by countries with bulging forex reserves. The Philippines needs to play the "poor country" card to the hilt, as the PRC is doing.

D Source Country Posture

There are countries which, because of singular successes, are natural FDI source countries. Japan and Taiwan are the most important source countries in our vicinity. The Philippines must formulate country postures that will incorporate and cultivate nuances (not necessarily fiscal incentives) to attract their business. Malaysian Prime Minister Mahathir is the most visible exponent of country posture. In his pronouncements and speeches, Dr. Mahathir originated the "Look East policy" designed to stir Malaysia away from "decadent" Western values to the ascendant East Asian ones, especially Japanese. This warmed the hearts of the Japanese companies. His position on whether a Japanese apology for WW II atrocities was proper played very well in Japan. In brief, Japanese corporations rewarded Malaysia with some of the largest exports of production facilities known in recent history. Country postures are FDI source targetting programs.

E. Reconfigure the Incentive Structure

The trade liberalization initiatives through the 80s and early 90s have managed to shift the incentive structure within the traded goods sector itself (which is now less punitive of exports *vis-a-vis* import substitution goods because of reduced rents to the latter). But these initiatives have not changed the relative incentive structure between traded goods and nontraded goods. The incentive structure is very skewed in favor of the latter. Trade liberalization and the strong peso are moving Filipino business out of traded goods (whether exports or import substitutes) into nontraded goods (witness the well-publicized diversification of Republic Flour into real estate!). The scant evidence there is shows that the share of Industry and Manufacturing in SEC-registered investments of new corporations is falling while that of the Service Sector is rising. This phenomenon has been exacerbated even as the economy recovered during President Ramos's term because of considerable peso appreciation.

Since new technologies are embodied in new capital equipment and this embodied technology represents 70 to 80 percent of technical upgrading, the rather low share of investment in tradeables implies very slow technical upgrading. Something has to be done

about the exchange rate which is the relative price of tradeables to nontradeables. When the peso appreciates, the price of tradeables falls relative to nontradeables and business correctly shies away from manufacturing. Something also has to be done about the tax system which allows profits from real estate to either escape payment or pay only a 20 percent capital gains tax ceiling.

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APPENDIX

Table 14A.1. Inflow of direct investment to major countries/regions, 1990-1994 (in US$ million)

	1990	1991	1992	1993	1994
U.S.	47,920	22,020	17,580	41,110	49,420
Canada	7,855	2,740	4,517	4,997	6,043
Mexico	2,549	4,742	4,393	4,389	7,978
U.K.	32,430	16,208	14,934	14,475	10,085
Germany	2,490	4,070	2,440	320	-3,020
France	13,183	15,149	21,843	20,755	17,183
Italy	6,411	2,401	3,105	3,749	2,199
Spain	13,984	12,493	13,276	8,144	9,700
Netherlands	12,349	6,316	7,700	6,084	3,473
Switzerland	4,961	3,178	1,249	699	3,684
Australia	7,077	4,903	4,310	3,381	3,789
Asia	17,506	19,670	24,240	43,463	48,605
Japan	3,760	1,370	3,720	100	890
South Korea	715	1,116	360	516	758
Taiwan	1,330	1,271	879	917	1,375
Singapore	5,575	4,879	2,351	5,016	5,588
Malaysia	2,332	3,998	5,183	5,006	4,348
Indonesia	1,093	1,482	1,777	2,004	2,109
Philippines	530	544	226	763	881
Thailand	2,444	2,014	2,116	1,726	640
China	3,487	4,366	11,156	27,515	33,787
Latin America	5,964	8,807	11,332	12,827	12,845
World	235,529	195,233	190,030	208,456	203,229

Source:

JETRO compilation based on IMF's International Balance of Payments (IFS) and Taiwan local statistics.

Notes:

1. Asia includes Korea, Singapore, Taiwan, Malaysia, Indonesia, Philippines, Thailand and China. (Asian figures for 1994 do not include the Philippines.)
2. Latin America includes Chile, Brazil, Mexico and Argentina. (Latin America 1994 figures do not include Argentina)
3. Figures for the U.S. are on a current value basis. Figures for the world are estimated by JETRO.

Table14A.2. Imports, exports and trade balance of the Philippines vs. People's Republic of China (in US$ million)

	1990	1991	1992	1993	1994
Imports	162.1	223.5	183.7	180.7	290
Exports	61.8	127.8	113.9	173.9	163
Trade Deficit	-100.3	-95.7	-69.8	-6.8	-127

Source: Department of Trade and Industry

Table14A.3. Foreign direct investment (FDI) and foreign portfolio investment (FPI) in the Philippines (in US$ million)

	1973-80	1989	1990	1991	1992	1993	1994
Total FDI:	2,869	203	1,169	577	371	509	801
United States	1,649	69	307	96	57	62	77
Japan	195	52	147	217	144	51	70
Total FPI:	23	437	346	298	727	1,491	3,229
United States	0.20	33	34	61	166	502	641
Japan	_	7.01	0.10	7.88	1.37	4.47	46

Source: Bangko Sentral ng Pilipinas

Table 14A.4 (a). Determinants of United States trade flows: 1980, 1985 and 1990

Year	Adj. r2	Degree of freedom	Constant	Investment stock (t-1)	Openness indicator (t-1)	Population (t-1)	Per capita GDP (t-1)	Distance
EXPORTS:								
1980	0.83	61	-3.61*	0.1222*	0.0098*	0.8542*	0.9698*	-0.8207*
			191	0.0472	0.0021	0.0900	0.1323	0.1300
1985	0.85	62	-1.82	0.2760*	0.0101	0.7398*	0.6869*	-0.7826
			1.94	0.0600	0.0024	0.1043	0.1476	0.1800
1990	0.85	52	1.91	0.2491*	0.0092*	0.8509*	0.4187*	-1.0430*
			2.41	0.0597	0.0024	0.1166	0.1802	0.2303
IMPORTS:								
1980	0.6	61	6.98	0.0253	0.0491*	0.9472	1.2044*	-0.7084*
			3.31	0.0819	0.0437	0.1560	0.2295	0.3200
1985	0.7	62	-7.97*	0.2309*	0.0066	0.7226*	1.2557*	-0.5116
			341	0.1222	0.0012	0.1852	0.2619	0.3344
1990	0.74	52	9.02*	0.0167	0.0107	1.1167*	1.5381*	-0.9928*
			3.50	0.0868	0.0135	0.1695	0.2619	0.3349

Source: Hufbauer, Lakdowalla and Malani, 1994.

Note: Underneath each coefficient is its standard error. An asterisk indicates that the coefficient is significant at the 90% confidence level or better.

Table 14A.4 (b). Determinants of Japanese trade flows: 1980, 1985 and 1990

Year	Adj. r2	Degree of freedom	Constant	Investment stock (t-1)	Openness indicator (t-1)	Population (t-1)	Per capita GDP (t-1)	Distance
EXPORTS:								
1980	0.81	35	-1.94	0.1715*	0.0050*	0.5740	0.9734*	-0.7037*
			2.36	0.0550	0.0024	0.1071	0.1431	0.2158
1985	0.85	39	-5.15*	0.1321*	0.0074*	0.7082*	1.1947	-0.7307*
			2.39	0.0501	0.0028	0.1063	0.1402	0.2166
1990	0.89	45	-5.58*	0.2291*	0.0064*	0.6682*	1.1113*	0.5872*
			2.33	0.0506	0.0022	0.1035	0.1487	0.1931
IMPORTS:								
1980	0.73	35	-1.85	0.4693*	0.0007	0.4451*	0.5337*	-0.3365
			3.57	0.0831	0.0037	0.1616	0.2161	0.3258
1985	0.8	39	-2.08	0..3769*	-0.0017	0.4670*	0.8709	-0.6178*
			2.93	0.0615	0.0035	0.1303	0.1719	0.2657
1990	0.81	45	-4.31	0.3605*	-0.0023	0.5386*	1.2349*	-0.7761
			3.73	0.0811	0.0035	0.1659	0.2383	0.3096

Source: Hufbauer, Lakdowalla and Malani, 1994.

Note: Underneath each coefficient is its standard error. An asterisk indicates that the coefficient is significant at the 90% confidence level or better.

Table 14A.4 (c). Determinants of German trade flows: 1980, 1985 and 1990

Year	Adj. r2	Degree of freedom	Constant	Investment stock (t-1)	Openness indicator (t-1)	Population (t-1)	Per capita GDP (t-1)	Distance
EXPORTS:								
1980	0.91	53	1.38	0.4018*	0.0033*	0.8542*	0.9698*	-0.6020*
			1.34	0.0656	0.0016	0.0900	0.1323	0.0861
1985	0.89	54	-3.18*	0.0508	0.0066*	0.7398*	0.6869*	-0.8099*
			1.58	0.0512	0.0021	0.1043	0.1476	0.0937
1990	0.89	50	-3.10	0.1613*	0.0051*	0.8509*	0.4187*	-0.7707*
			1.99	0.0600	0.0018	0.1166	0.1802	0.1067
IMPORTS:								
1980	0.81	53	0.18	04401*	0.0039	0.9472	1.2044*	-0.4286*
			2.02	0.0990	0.0025	0.1560	0.2295	0.1299
1985	0.80	54	2.70	0.0692	0.0052*	0.7226*	1.2557*	-0.6993*
			2.06	0.0666	0.0027	0.1852	0.2619	0.1220
1990	0.86	50	2.33	0.1071	0.0058*	1.1167*	1.5381*	-0.7083
			2.04	0.0913	0.0019	0.1178	0.1945	0.1094

Source : Hufbauer, Lakdowalla and Malani, 1994.

Note: Underneath each coefficient is its standard error. An asterisk indicates that the coefficient is significant at the 90% confidence level or better.

Table 14A.5 World Competitiveness Report (WCR) factors of competitiveness

Factor I	Domestic Economic Strength	macroeconomic evaluation of the domestic economy overall
Factor II	Internationalization	the extent to which the country participates in international trade and investment flows
Factor III	Government	the extent to which government policies are conducive to competitiveness
Factor IV	Finance	the performance of capital markets and the quality of financial services
Factor V	Infrastructure	the extent to which resources and systems are adequate to serve the basic needs of business
Factor VI	Management	the extent to which enterprises are managed in an innovative, profitable and responsible manner
Factor VII	Science and Technology	scientific and technological capacity, together with the success of basic and applied research
Factor VIII	People	the availability and qualifications of human resources

Source: World Competitiveness Report (1992)

Table 14A.6 WCR By Country and Factor (1992)

	Domestic Economic Strength	Internationalization	Government	Finance	Infrastructure	Management	Science & Technology	People
ARGENTINA	35	28	14	23	31	32	37	28
AUSTRALIA	20	24	9	15	5	18	16	12
AUSTRIA	19	12	16	9	11	11	11	7
BELGIUM	16	10	38	16	15	17	10	14
BRAZIL	41	36	35	36	30	35	38	37
CANADA	15	19	22	8	2	19	19	17
CHILE	23	16	7	19	21	16	26	24
COLOMBIA	32	37	17	29	36	27	28	29
CZECH REPUBLIC	36	27	31	37	40	40	25	38
DENMARK	13	9	15	10	13	6	9	2
FINLAND	27	26	18	32	7	9	7	10
FRANCE	14	5	28	18	10	20	6	16
GERMANY	12	4	12	7	9	12	3	3
GREECE	34	32	39	34	37	34	36	34
HONGKONG	4	3	2	3	17	4	20	18
HUNGARY	39	38	36	38	34	39	40	35
INDIA	22	33	27	27	41	33	29	40
INDONESIA	25	34	24	30	32	36	30	33
THAILAND	8	11	23	17	23	22	17	15
ITALY	24	20	41	35	35	25	22	25
JAPAN	3	8	19	5	24	1	1	4
KOREA	7	39	30	39	29	31	18	20
MALAYSIA	6	14	4	13	18	14	24	22
MEXICO	30	31	10	31	28	26	32	31
NETHERLANDS	17	6	25	6	12	10	14	9
NEW ZEALAND	11	25	3	12	8	8	21	13
NORWAY	21	23	20	22	1	15	12	13
PHILIPPINES	21	23	29	22	39	15	34	36
POLAND	38	41	40	40	38	41	35	32
PORTUGAL	31	22	26	28	26	37	39	26
SINGAPORE	2	2	1	2	16	7	8	1
SOUTH AFRICA	37	35	37	21	20	29	27	41
SPAIN	29	15	32	33	22	30	23	27
SWEDEN	26	13	21	26	4	2	5	8
SWITZERLAND	10	18	5	4	6	3	4	11
TAIWAN	5	17	11	20	27	21	15	19
THAILAND	9	21	8	14	33	23	31	23
TURKEY	33	29	33	24	19	24	33	30
UNITED KINGDOM	18	7	13	11	14	13	13	21
USA	1	1	6	1	3	5	2	6
VENEZUELA	40	40	34	41	25	38	41	39

Source: WCR (1992)

Table 14A.7. Distribution of Philippine exports by major commodity group (in percent)

	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
Coconut Products	10.07	9.79	9.90	8.22	6.92	6.14	5.06	6.55	4.68	4.75	6.19
Sugar & Products	4.00	2.13	1.24	1.05	1.44	1.62	1.54	1.12	1.13	0.57	0.73
Fruits & Vegetables	5.53	5.68	4.95	4.33	4.08	3.98	4.45	3.78	3.66	3.19	3.06
Other Agro-based	5.85	7.52	6.57	6.79	5.80	5.27	5.70	4.40	4.18	3.95	3.51
Forest Products	4.30	4.15	4.25	3.69	2.52	1.16	0.83	0.58	0.40	0.19	0.19
Petroleum Products	12.31	11.13	8.08	10.80	10.60	8.83	5.90	6.44	6.03	5.76	5.67
Mineral Products	1.97	1.94	2.33	2.29	1.21	1.89	1.98	1.53	1.20	0.98	0.85
Manufactures	54.85	55.18	59.97	61.32	66.39	69.70	72.43	74.24	76.74	78.81	77.59
Special Transactions	0.26	0.17	0.12	0.38	0.13	0.23	0.19	0.38	0.33	1.03	0.59
Re-exports	0.86	2.31	2.60	1.13	0.91	1.16	0.93	1.00	1.45	0.77	1.63
Share of Selected Manufactures:											
Electronics, Elect. Eqpt. Parts & Telecoms	22.61	18.98	19.56	20.86	22.39	23.39	25.94	28.02	31.22	37.10	41.31
Garments	13.46	15.51	19.20	18.62	20.14	21.70	21.05	21.78	19.97	17.65	14.40

Source of basic data : Bangko Sentral ng Pilipinas

Table 14A.8. Distribution of Philippine imports by major commodity group (in percent)

	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
Raw Materials	6.83	8.35	7.65	7.65	7.75	7.06	6.98	6.52	5.57	5.94	6.50
Semiprocessed R-M	38.92	47.58	46.79	46.46	43.97	40.52	41.57	40.03	39.06	39.05	39.80
Mineral Fuels & Lube	28.41	17.23	18.54	13.43	13.41	15.09	14.80	14.12	11.46	9.54	10.20
Consumer Goods	6.26	5.41	5.80	7.32	8.62	8.69	8.22	8.55	9.02	9.83	9.40
Special Transactions	4.54	4.80	4.53	5.07	2.99	3.06	3.93	3.07	3.01	3.34	3.90

Source of basic data : Bangko Sentral ng Pilipinas

Table 14A.9. Direction of Philippine external trade by major country/region, 1985-1995 (in percent)

	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
EXPORTS (% of total):											
United States	35.73	35.46	36.08	35.57	37.66	37.81	35.57	39.01	38.43	36.03	34.54
EEC	14.02	18.77	19.04	17.66	16.95	17.70	19.57	18.92	17.34	17.02	17.72
Japan	18.90	17.68	17.15	20.07	20.28	19.74	16.06	10.14	15.97	14.90	15.81
Hongkong	4.04	4.56	4.88	4.89	3.87	4.03	3.91	3.10	4.82	4.83	4.97
Korea	1.56	2.31	1.69	2.28	2.26	2.81	1.82	1.78	1.94	2.16	2.68
Singapore	5.40	3.24	3.44	3.17	2.60	2.93	2.53	2.25	3.34	5.24	5.60
Taiwan	1.86	2.56	2.52	2.84	2.60	2.55	2.27	2.14	3.04	3.35	3.05
Indonesia	0.39	0.60	1.14	0.36	0.73	0.75	0.31	0.57	0.42	0.53	0.01
Malaysia	3.76	2.02	2.08	1.65	1.29	1.55	1.32	1.01	1.42	1.63	1.63
Thailand	1.90	1.43	2.20	1.75	1.97	1.91	1.39	1.58	1.49	2.70	4.92

Source of basic data: Bangko Sentral ng Pilipinas

(continued on next page)

Table 14A.9 (continued)

	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
IMPORTS (% of total):											
United States	25.09	24.90	22.09	21.02	18.97	19.38	20.13	18.05	20.01	18.41	17.60
EEC	8.39	11.08	11.55	11.69	11.12	11.05	10.20	11.72	10.13	10.27	11.05
Japan	14.38	17.21	16.64	17.42	19.60	18.29	19.48	21.20	22.90	24.25	21.95
Hongkong	3.87	5.11	4.63	4.58	4.61	4.56	4.95	4.97	4.98	5.13	4.72
Korea	3.99	3.37	2.94	4.06	4.06	3.92	5.05	4.80	5.10	5.17	5.13
Singapore	2.62	2.46	3.44	4.11	4.71	3.99	3.78	3.80	5.56	6.73	5.27
Taiwan	3.48	5.55	5.52	6.26	6.73	6.60	6.85	6.60	5.82	5.72	5.72
Indonesia	3.62	2.54	1.32	1.03	1.52	1.50	1.34	1.25	1.94	1.71	2.31
Malaysia	7.24	4.28	3.93	3.05	2.56	2.23	2.47	2.67	2.02	2.01	1.98
Thailand	0.98	0.57	0.70	0.64	0.80	1.13	0.78	0.95	0.97	0.92	0.97

Source of basic data: Bangko Sentral ng Pilipinas

Table 14A.10 Philippine exports, imports and trade balance vis-a-vis major trade partners, 1985-1995 (in US$ million)

	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995:S1
(a) EXPORTS											
United States	1,654	1,717	2,064	2,516	2,945	3,095	3,144	3,832	4,371	5,128	2,758
EEC	649	909	1,089	1,249	1,326	1,449	1,642	1,859	1,972	2,295	1,415
Japan	875	851	981	1,420	1,586	1,516	1,420	1,586	1,817	651	1,262
Hongkong	187	221	279	346	303	330	345	305	548	291	397
Korea	72	112	108	161	177	230	161	175	221	707	214
Singapore	250	157	197	224	219	240	224	221	360	452	447
Taiwan	86	124	144	201	210	209	201	56	346	72	244
Indonesia	18	29	65	27	57	61	56	99	48	220	65
Malaysia	174	98	119	117	101	127	99	155	161	364	130
Thailand	88	69	126	124	154	156	155		169		393

Source: Bangko Sentral ng Pilipinas

(continued on next page)

Table 14A.10 (continued)

	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995:S1
(b) IMPORTS											
United States	1,282	1,256	1,488	1,715	1,977	2,366	2,426	2,620	3,522	3,927	2,174
EEC	429	559	785	954	1,159	1,349	1,229	1,702	1,782	2,190	1,352
Japan	735	868	1,121	1,421	2,042	2,232	2,347	3,076	4,030	5,173	2,702
Hongkong	198	258	312	374	480	556	596	721	877	1,094	581
Korea	204	170	198	331	423	478	609	551	898	1,103	632
Singapore	134	124	232	335	491	487	455	960	978	1,435	649
Taiwan	178	128	372	511	701	606	325	181	1,025	1,221	704
Indonesia	185	216	69	84	158	183	162	387	341	305	284
Malaysia	370	29	268	249	267	272	298	138	355	429	244
Thailand	50	_	47	52	83	138	94	_	171	197	119

Source: Bangko Sentral ng Pilipinas

(continued on next page)

Table 14A.10 (continued)

	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995:S1
(c) TRADE BALANCE											
United States	372	461	576	801	968	729	718	1,212	849	1,201	584
EEC	220	350	304	295	167	100	413	157	190	105	53
Japan	140	-17	-140	-1	-456	-616	-927	-1,492	-2,213	-3,164	-1,440
Hongkong	-11	-37	-33	-28	-177	-226	-250	-416	-329	-443	-184
Korea	-132	-58	-90	-170	-246	-248	-448	-522	-677	-812	-418
Singapore	116	33	-35	-111	-272	-247	-231	-330	-598	-728	-202
Taiwan	-92	-156	-228	-310	-491	-597	-624	-750	-679	-789	-460
Indonesia	-167	-99	-24	57	-101	-122	-135	-125	-293	-293	-219
Malaysia	-196	-118	-149	-132	-166	-145	-181	-288	-194	-209	-114
Thailand	38	40	79	72	71	18	29	17	-2	167	274

Source: Bangko Sentral ng Pilipinas

COMMENTS

*Emmanuel De Dios**

Dr. Fabella's first point is that with globalization, a country like the Philippines lives in a harsher environment. He says this is because aggressive new players have emerged, chief of which is China. Second, there has been a recasting of the rules. The WTO has a more encompassing scope including, for example, intellectual property rights and trade in services. Thus, certain avenues of opportunity that were open to the first-tier NIEs are no longer open to us. Capital mobility, particularly of portfolio capital, threatens the macroeconomic stability of certain countries.

Dr. Fabella asks how we are to respond to this. And his answer is divided into two, one based on experience and the other based on theory. The experience part is the allusion to Taiwan and the dilemma of whether to import technology or to import firms. Taiwan was able to do both but the import of bundled technology through firms has become more predominant because technology is now less and less available in disembodied form. Recent writers on technology have noted the fact that many developments are actually carried on within firms. And even without the protection of patents for trade secrets, the fact that knowledge is tacit enables firms to follow a trajectory of technological development which others outside that firm will find difficult to emulate. This explains why South Korea is having a harder time than Taiwan. But the other point is that externalities regarding technologies are actually difficult to predict. It is difficult to determine what leaks out and what stays in.

Dr. Fabella's theoretical answer to the question is, for me, more interesting because I have been struggling with the same question. For Dr. Fabella, national competitiveness is a significant factor. He poses the question of whether the concept of comparative advantage is *passé* or not and his answer is, it is not. But I do not really know what the answer is because I pose the question differently. The real question for comparative advantage is Joan Robinson's old question of whether an economy can or cannot be outsold all around.

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Under the comparative advantage theoretic, you always have something to sell. You can always sell something because what matters is not absolute efficiency but comparative efficiency. You may be equally or universally inefficient, or more inefficient than another country, but because you are not equally inefficient in everything, there is still something that you can sell. A suspension of that principle would be to say that you have nothing to sell. Recall that the question is whether a country can be outsold all around. The new element that is inserted here, and it is an important one, is factor mobility. If we accept this question the way it is posed and factor mobility is assumed, you are no longer sure that comparative advantage is still relevant. It is possible in that sense for a country to be outsold all around. What distinguishes regions from nations is factor mobility. Within a region you have factor mobility; between nations you do not have factor mobility.

It is an outcome of regional theory, however, that countries can be backwaters and lagging regions. Krugman, in a recent publication on geography, has said that even in the United States you have some lagging regions and all the industries are concentrated in others. The real dilemma, from a theoretical point of view, is whether the world is not changing in that manner. I suppose the Philippines has the luxury of still being able to point to certain things that can go. But think of a country, say in sub-Saharan Africa, where the so-called immobile factors are completely absent. Can we say that comparative advantage in such a region makes a lot of sense?

It is of course an exaggeration to say comparative advantage is entirely irrelevant because with the proper exchange rate, you can always sell something. But the message I received is that in an era of factor mobility and rapid technological change attained through learning by doing, if industries are concentrated in a certain area and they are no longer available to the other areas, then the gap between areas will widen. The lagging region can still sell something since there is always an exchange rate that will balance trade. And with balanced trade you can always sell some commodities and import others. Realistically, however, the worsening of the terms of trade that this will entail for those regions may or may not be realizable. Internally, it will require some adjustments. Think of how an underdeveloped country in terms of hard and soft infrastructure,

would catch up with an aggressive trading nation like China, by adjusting its exchange rate to the point that its comparative advantage is manifested. That would be a very difficult thing to do. Still, it is true that by accepting a decline in terms of trade, a country can balance its trade. But to do this can amount to such a worsening of standards of living that it might not be politically acceptable.

The message I get, therefore, is that we live in perilous times. We live in a harsher environment requiring a greater degree of ingenuity and skill on the part of governments, as well as a greater consciousness of national interests, for states to survive the era of globalization.

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Index

A

absent market, 43
Addison, Tom (1987), 215
AGENDA 21 project, 333
agricultural research, 47
agriculture, xxxii; 44, 47; protectionism in, xxxiii, 14, 151-166, 211-213, 233,405
air transportation, 94
Alburo, Florian A., xxix, 3-24
Aldaba (1996),184
anti-dumping agreement, 410
Aquino administration (1986), 29, 45, 196
Argentina, 203
Arrow, Kenneth J. (1971), 33
ASEAN Labor Ministers, 178
ASEAN Regional Forum (ARF), 66, 68
Asia Pacific Regional Operations Center (APROC), 444
Asia-Pacific Economic Cooperation (APEC), xxvii, 8, 12, 30, 63-67, 194, 363
Asia-Pacific, 68
Association of Southeast Asian Nations (ASEAN), 5, 30, 65, 177, 363
Association of Southeat Asian Nations Free Trade Area (AFTA), xxvii, 8, 30, 65, 194, 363, 429
Attrition Law, 38
Australia, 8, 12
Austria, Myrna (1992), 1992

B

backard-forward linkage effects, 85-86 (Table 4.6), 86, 104
Bacungan, Froilan M.,191-192 (comments to Esguerra)
balance-of-payments (BOP), 44
Balisacan, Arsénio, xxxii, 151-166
Balisacan (1995), 201
Bangko Sentral ng Pilipinas (BSP), 37, 40
Bank of International Settlements (BIS), 90
banking sector, 88-89

banking system, 41, 48
Banuri (1991), 203
Barings, 432
basic research, 267
Bello, Walden (1995), 204
Berne Convention on Copyrights, 295
biological diversity issue in the Philippines, 340
Bogur Statement, 66
Bourguignon, Francois and Christian Morrisson (1989), 207
Brazil, 203
Brecher-Diaz Alejandro Welfare Proposition, 449
Bretton Woods institutions,71, Agreement in 1944, 358
Buchanan, Pat, 69
budget process, 42
Build-Operate-Transfer (BOT) Law, 42
Bureau of Internal Revenue (BIR), 38
Buvinic, Mayra (1988), 219

C

Candelaria, Sedfrey, 419-421 (comments to Sereno)
Canlas, Dante B., xxx, 29-54
capital and financial markets, 47
capitalism, postwar era, 57; styles, 63
capitalist development, 63
Carribean Basin Initiative, 176
catch-up or convergence hypothesis, 257-258
Cellular Mobile Telephone Services (CMTS), 98
Central Bank of the Philippines (CB), 39
Child Labor Deterrence Act of 1995, 178-179
child labor, 183
children, 219-20
Chile, 434
Citibank, 118
civil society, xxv, in the Philippines, 64,71
Clarete, Ramon, xxxv, 275-299
Clark, Colin (1951), 124
"classical" capitalism, xxx
Coase, Ronald, 31
collective bargaining, 172

Commission of Advanced Study of the United Nations, 70
Committee on Tariff and Related Matters, 47
Common Effective Preferential Tariff (CEPT), 30
communism and central planning systems, 3, 9, 26
comparative advantage, xxxvii, 436, 447, 485-486
competitive markets, 32, 36
competitiveness, productivity and technology, 234, 249-258, 453, 459
complete markets, 43, 47
computer services, 103
computer software and databases, 103, 282
Condominium Law, 57
consumer responses, 32
cooperatives, 160
Cooper, Richard N. (1985), 352
copyright and related rights, 282
cost internalization, 330-332
Council for Scientific and Industrial Research (CSIR), 254
Covenant's Article 2, 214
credit market, 41
Crisostomo, Cristina (1972), 237
current research, classification of, 259-260
customs valuation agreement, 410

D

Daiwa Bank fiasco, 432
David, Cristina, xxxii, 151-166
De Dios, Emmanuel, (comments to Sereno), 485-487
debt instruments, 47
Dee, Dewey, 88
deindustrialization, 57
Del Monte, 176
Demery, Lionel (1987), 215
democratic deficit, xxxi, 69-72
democratization demands, 19, 72
Department of Agrarian Reform, 159
Department of Budget and Management (DBM), 39
Department of Environment and Natural Resources (DENR), 333, 339
Department of Finance (DOF), 39
Department of Science and Technology (DOST), 269, 272, 273

Department of Transportation and Communication (DOTC), 92
'DOTC Department Circular No. 87-188, 96
Department Order No. 92-587, 95
deregulation, 203, 457
devaluation, 40, 203
developing economies, 29
Development Alternatives, Inc. or DAI, 250, 252
Development Budget Coordination Committee (DBCC), 38, 39
devolution, 51, 160, 194
direct foreign investment and TRIPS agreement, 300
division of labor, 124, 126-131, 135, 442
Dornbush, Rudiger (1992), 193
Dy (1996), 270

E

Earth Summit in Rio de Janeiro, 1992, 214
East ASEAN Growth Area (EAGA), 194, 429
eco-labelling, xxxv, 320-322
Economic and Social Council (ECOSOC), 70
economic crisis, 149, 1984-85, 202
economic growth and development, 124, 131-133, styles, 63
economic integration, 181
economic interdependence and labor standards, 175
economic policy coordination, 358, Philippines, 362, 367, 369, 384
economic reform package, 193 (Philippines)
economies of scale, 52, 131
educational institutions, 102
education, 51, 200, 217, 238, 458
Ehrenberg (1994), 181
Emerging World Environment (EWE), trends, xxvii, xxix
emerging world economic environment , overview, 3-27,
global responses, 9, causes,19
EWE Research Program,UP-CIDS, xxv
Emerging World Economic Order, 57, 424-487
employment conditions, 171-172
environment policies, 311
environmental impact assessment (EIA) systems, 341
environmental protection and trade liberalization, xxxv
equity and efficiency,balance, 61, 195, 196

erzatz capitalism, 443
Esguerra, Emmanuel, xxxiii, 167-190
European Community (EC), xxvii, 6, 57
European currency unit (ECU), 360
European Monetary Union, 360
European parliament, 71
European System of Central Banks, 360
European Union, xxvii, 12
exchange rate policy, 49-50
Executive Order (E.O.) No. 264, 29, 46
Executive Order (E.O.) No. 470, 46
Executive Order (E.O.) No. 70, 45
export processing zone, 443
externality and market failure, 35

F

Fabella and Paderanga (1996), 459
Fabella, Raul, xxxvii, 423-486
Feeney, Patricia (1994), 214
Fields, Gary (1988), 208
Filipino values, 53
final-use services, 149
financial sector, 88, 120
Financial Times, 58
fiscal authority, 37
fiscal policy, 37
Fisher, Alan (1939), 124
fixed exchange rate, 44
floating rate system, 359
food security, xxxii, 151-166
food supply, xxxii, food prices, 152
foreign direct investment stocks, (Table 1.2), 14, 347, 350, 438
foreign direct investments (FDIs), xxvii, xxxvii, 12,
Japan (Table 1.1), 13, 430-442, 449, 459
foreign equity, 48
foreign insurance companies, 57
Foreign Investments Act (FIA) of 1991, 29, 48, 89
foreign trade policy regime, 43, 205, effects, 207-8
foreign-debt crisis, 44

formal rules, 60
free trade zone, 443
free trade, 17, European, 9, 64
Friedman, Milton, 40

G

General Agreement on Tariffs and Trade (GATT), 6, 178, (1994), 394; GATT LAW, 395-398
General Agreement on Trade in Services (GATS), 124, 136, 415
General Banking Act, 57
Generalized System of Preferences (GSP), 176, 276
geographical indications, 283
global competitiveness, 64
global crisis, 57
global economic integration, xxv
global economic transactions, 3
global firm, 10, 60
global market reform, 29
globalization process, 58, effects on the informal sector, 193-233
globalization, 9-12, limitations, 16, on agricultural countries, 18, trade and investments, 25
globalization, implications for the Philippines, 423-487
government intervention, 33,60
government services sector,traffic law enforcers, 121
Gowa, Joann (1994), 66
Graham, Carol (1994), 215
Grober, Gunther (1988), 360
gross national product (GNP), 39, 49
growth accounting approach, 236, 238

H

Harrison, Glenn, Thomas Rutherford, and David Tarr (1995), 354
health, 51, 200
high-performing Asian economies (HPAEs), 248
Hirschman's exit-voice framework, 171
Hsinchu Science Industrial Park (HSIP), 444
human resource development, 47
human rights,182, and development, 214

I

imperfect competition, 36
import liberalization program, 29, 45
import-substitution, 30, 43
indigenous peoples, tribes, 26, 213
inderect tax, 38
Indonesia, 131, 145-148
industrial designs, 284
Industrial Technology Research Institute (ITRI), 445
inflation, 38, 39, 42; inflation rate, 40
informal rules, 60
informal sector, xxxiv, 81, 193-233
information industry, 458
information problem, 34
information technology and infrastructure, 457
input-output table, 85
insider trading, 48
Institute of Information Industry, 445
institutional challenges, 31
insurance industry, 90
insurance market, life and non-life, 33-34
Intal, delos Angeles, Medalla et al, study, 331
Intal, Ponciano, xxxv, 307-338, 385 (comments to Paderanga,Jr.)
integrated economy, 181, 345
intellectual property rights (IPR), xxxv, 26, 103, 275
    agreements on trade-related aspects, 416
    enforcement and dispute settlements, 286
    on generic drug policy, 213, 275-305
    protection to plant varieties, 294
    IPR to indigenous communities, 293
intelligent industrial parks, 444
interdependence, 351-353
interest-group competition, 52
interisland shipping, 93
International Bill of Rights, 182
International Confederation of Free Trade Unions (ICFTU), 168, 179
international economic law, 389
International Human Genetic Diversity Project, 213
International Labor Organization (ILO), 57, 69, 175, 178, 182, 191

international law in Philippine law, 387
International Monetary Fund (IMF), 39, 58, 70
international trade, effects on the environment, 309-311
international trade, 43, 177, "greening of", 314, 318
Investment Coordination Committee (NEDA), 52
ISO 14000, xxxv, 308
Israel, 203

J

Japan External Trade Organization (JETRO) Survey, 454
Japanese economy, 57, investments, 58, 60, 64

K

Kahler (1990), 203
Kelly (1994), 199
Kemp-Jones Model, 448
Kendrick (1961), 237
Killick, Tony (1993), 215
Krueger (1996), 178
Krugman, Paul and Maurice Obstfeld (1988), 195
Kuznets (1974), 124

L

Labor Code, 42
labor cost, 170
labor standards in open economies, 167-188
labor standards, 169-186, 191
labor union, 172
labor, as internationally shared resource, 25, casualization of, 233
Lallana, Emmanuel, xxx, 66-68
Lamberte, Mario, xxxi, 75-116
land conversions or development aggression, 214
Land Transportation Franchising Regulatory Board (LTFRB), 92
Langille (1994), 180
Lavina, Antonio, 339-342 (comments to Intal,Jr.)
layout-designs of integrated circuits, 284

leapfrogging strategy, 258
Lee Kuan Yew, 26
liberalization, xxx; 25, 46, 65; in agriculture, xxxii, 123-150
Lipton, Michael (1995), 217, 220
Llanillo, Llewelyn, 303-305 (comments to Clarete)
Llanto, Gilbert, 149-150 (comments to Mehta)
Local Government Code, 38, 51
local government units (LGUs), 51, 61
Lucas, Robert, 40
Lugar, Richard (Senator), 67
Lycette, Margaret (1988), 219

M

Maastricht Treaty, 8, 69
Macaranas, Federico M., 25-27 (comments to Alburo)
Machiavelli, Niccolo, 194
macroeconomic coordination for the Philippines, 362-367
macroeconomic policy, 40-42
Magallona, Merlin M., 57-59 (commentss to Canlas)
Magna Carta for Small Farmers, or Republic Act No. 7606, 213
Malaysia, 64, 131, 145-148, 333
Mangahas, Mahar, 221
Manila Bulletin, the classified ads newspaper, 272
Maravall (1994), 215
Marcos, Ferdinand E., 45, 196
marginal sector, 198, 200
Maritime Industry Authority, 93
market balance, 32
market intervention, 61
market reform, 28-62, 193, problems, 195
market transformation, 5
market-oriented policy agenda, 31
markets, planning and regulation, 50
Marrakesh Agreement, 399
Marrakesh Protocol to GATT 1994, 404
Matsushita Taiwan, 443
Medalla, Felipe M., 60-62 (comments to Canlas)
medium-term development plan, 41
Mehta, Nimai, xxxii, 123-148

Mendoza Jr., Amado, xxxiv, 193-231
Mexico, 434
migration of capital, 57
Migros, 176
minimalist state, 63
mining law, 57
monetary policy, 37, 41
money supply growth, 41
Montes, Manuel (1994), 222
Montes, Vaughn, 117-119 (comments to Lamberte)
Montreal Protocol, 322
multi-fiber agreement, 13, 16
multilateral organization, problems of governance, 63
multilateralism, xxx, 63-72
multinationals, 57
multi-year budgeting, 42
Myanmar, 60

N

Nathan Associates,Inc., 91
National Economic Development Authority (NEDA), 39
National Food Authority (NFA), 33, 159
national interest, in globalization, 58
National Statistical Coordination Board (NSCB), 78
National Telecommunications Commission (NTC), 97
national treatment principle, 58
natural resources management, 342
Negative List C, 29
Negative Lists A, B, and C, 47
neostructuralist, 203
New Zealand, 8, 12, 435
newly-industrializing countries of Southeast Asia, 63
newly-industrializing countries (NICs) of East Asia, 63, 217, 435
newly-industrializing economies (NIEs), 12, 44
nongovernment organizations (NGO), 71, 214
non-market allocation, 33
non-tariff barriers (NTB), xxviii, 6, 7, 15
nontradeable services sector of the Philippines, 75-121

North American Free Trade Agreement (NAFTA), xxvii, 8, 178, 428
Northwest Luzon growth triangle, 194
North, Douglas (1990), 31, 174-175
Noyelle, Thierre (1990), 103

O

official development assistance (ODA), 30
Ofreneo, Rene, 232-233 (comments to Mendoza Jr.)
oil industry deregulation, 40
Olson syndrome, 222
Omnibus Trade and Competitiveness Act of 1988, U.S., 176, 276
one state-one vote formula, 70
O'neill,Tip, 61
Organization for Economic Cooperation and Development (OECD), 64
organized labor in the Philippines, 184, 185
orthodox paradox,198
Osaka Declaration, 66
Overseas Private Investment Corporation, 176

P

Paderanga (1996), 365
Paderanga, Jr. Cayetano, xxv, 345-383
palay, 33
Paris, Tirso (1971), 237
Patalinghug, Epictetus, xxxiv, 235-260
Patalinghug, Epictetus (1980), 237
patent of life-forms, 26
patents, 281, patent searches, 304
People's Republic of China, 4, 12, 26, 425-427
Peru, 203
Petron, 29
pharmacological knowledge, 26
Philippine Airlines (PAL), 95
Philippine Council for Advanced Science and Technology Research and Development (PCASTRD), 269
Philippine Council for Industry, Energy, Resource and Development (PCIERD), 269

Philippine Deposit and Insurance Company (PDIC), 48
Philippine economy, 29, 58, 132, 149, 161, 462-468
Philippine Human Development Report 1994, 200
Philippine Labor Code, 184
Philippine Long Distance Telephone Company (PLDT), 29, 99
Philippine National Bank (PNB), 29
Philips Taiwan, 446
Plaza Accord in 1985, 65, 435
policy coordination for the Philippines, 367
policy coordination, economics of, 361, 368
policy interdependence, 352
policy reform program, 53
policy research, 271
policy-making, in the Philippines, 58
political support, 195
Polluters Pay Principle, 330
pollution intensity, 323, 325
poor, 201, urban poor, rural poor, 202, 205, 209-224;
    pro-poor programs, 215
portfolio capital, 432-435; flows, xxvii
Posadas, Linda, 268-270 (comments to Patalinghug)
poverty, 198, 200, 217
power elites, 62
pragmatic zig-zag approach, 204
pre-need companies, 91
Presidential Decree (PD) No. 285 or the Reprinting Law, 292
price system, decentralized, 37, 61
private services, 102
privatization, 16, 29, 124, 203
producer services, 123-150, 134, 149
production function approach, 236
productivity ration approach, 236
productivity, Philippines, 235-274
professionalization of the bureaucracy, 31
progressive realization, 214
protectionism, 151, 205, green protectionism, 317
public goods provision, 36, 52, 61
public sector account, 37

Q

quantitative import restrictions, List A, List B, List C, 46
quantitative restrictions (QRs), 30, 94

R

R & D-led growth, 272
Ramos administration, 29, 46
Ramos, Victor, 339, 341
Ravalo, Johnny Noe, 120-121 (comments to Lamberte)
Raynor (1993), 104
real wages, 52
reengineering, 31
regional trading blocs, 428
Regional Tripartite Wage and Productivity Boards (RTWPD), 42
regionalism vs. multilateralism, 63-72
regionalization, 8
Reich, Robert, 59
rent seeking, 45, 160
Republic Act (RA) No. 166 or the Trademark Law, 292
Republic Act (RA) No. 772, 48
Republic Act (RA) No. 7606, 213
RA 165 or the Patents Law, 292
research and development, Philippines, 255-260, 268-9
    South Korea, 254-255, 266, 444
    Taiwan, 445-446
    U.S., 255, 267
research institutes, 444
research issues, 26, 271
retail stores, 100
retail trade liberalization, 29, 101
Retail Trade Nationalization Act, 57
rice trading, 33, 152-157, 212
risk and uncertainty, 33
Rivera, Temario C., xxx, 63-65
road transport system, 91-93
Robinson, Joan, 197
Robles, Alfredo, xxviv, 69-72
Rome Convention, 303

Rosenberg, Nathan (1990), 253, 254
rules, 60
rural banks, 88

S

safety net package, 197
Sakai (1994), 365
sanitary and phytosanitary measures, 407
science and technology, research and development, 268
second-generation policy reforms, 52
Securities and Exchange Commission (SEC), 48, 90
Sengenberger and Campbell (1994), 175
Sereno, Maria Lourdes (1995), 180
Sereno, Maria Lourdes, xxxvii, 384 (comments to Paderanga,Jr.), 387-418
services in economic development, xxxi, 75-140
services sector and subsector, 26, 75-138, World Bank definition, 77, (Table 4A.1 to 4A.3)
shipping industry, 118
Singapore, 64, 131, 145-148
skills, 200
Smithian model policy positions, 134-138
Smithsonian Agreement, 359
Smith, Adam, 126-130
social clause, xxxiii, 167-188, disguised protectionism, 177
social sectors, 198
Social Weather Station, 221
socialist economies, collapse of, 57
Societe Generale de Surveillance, 46
South Korea, 161
stabilization, eclectic or heterodox, 203
state and civil society, 64
state capacity, 195
state-centric organizations, 71
statist intervention, 63
"statist" capitalism, xxx
stock markets, 48, 90
strikes, 184
structural interdependence, 352

structural reform, 203
subcontracting, 185
sui generis protection system, 293 ; UPOV 1978, 294
Super 301, 277
superstores, 57

T

Taiwan, 161, 163, 443
Talisayon, Serafin (1994), 258
271-273 (comments to Patalinghug)
Tanada, Wigberto (Senator), 233
tariff rate of crude oil, 45-47
tariff reform programs, 45
tax and property reform, 203
tax structure policy, 37
Taylor, Lance (1993), 203
technological convergence, 257-258
technology import vs. import of firms, 442
technology, xxxiv, 26, 235
Tecson, Gwendolyn (1993), 93
telecommunications sector, 29, 96-99
textiles and clothing, 14, 232, 408
Thailand, 131, 145-148
theory of comparable advantage, 126 (see also comparative advantage)
Theory of International Trade, 177
theory of the second best, 60
thrift banks, 89
tiger economies, 63
Tokyo Round, 6, 394
total factor productivity (TFP), 52, 236, 241, 242-248, 444
trade and current account deficits, 44
trade and environmental linkage, xxxv, 307-342
trade and investment policies, 43
trade and investments, in the Philippines, 57
Trade and Tariff Act of 1984, U.S., 276
trade in securities, 47
trade in services (GATS), xxviii

trade liberalization, 8, 58, 65, 125, 134
reasons for the Philippines, 193, 203, 206-210
trade secrets, 284
trade theory, 447-452
tradeable services, 97, 123-150
trademarks, 283
trade-related aspects of intellectual property rights (TRIPS), xxviii; xxxv, 275, 293
TRIPS agreement on the Generic Law, 293
enforcement mechanism, 295, 301
overview, 278-281, implications, 287-291, Philippine compliance, 292-296
trade-related investment measures (TRIMS), xxviii, 357
transnational capital, 58
transnational corporations (TNCs), 436-438, 446
transport sector, 91
trucking industry, 92

U

underground economy, 199
unemployment, 57
unfair labor practices, 184
Union of Soviet and Socialist Republics (USSR), 3
United Nations Children's Fund (UNICEF), 204
United Nations Conference on Trade and Development (UNCTAD), 125
United Nations, 71
United States, 57, 64
University of the Philippines Center for Integrative and Development Studies (UP-CIDS), xxv
UP-CIDS Emerging World Order Conference, Feb. 29, 1996, xxv
University of the Philippines School of Labor and Industrial Relations 1987 study, 200
Uruguay Round (UR) agreements, 58, 193, 398-416, welfare effects (Table 12.3), 356
agreement on preshipment inspection, 411
agreement on rules of origin, 411
agreement on safeguards, 415

agreement on subsidies and countervailing measures, 412
agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS), 275
agreement on trade-related aspects of investment measures, 409
Uruguay Round (UR) agenda at Punta del Este 1982, 277
UR geographical bias, 17
Uruguay Round of Multilateral Trade Negotiations, 394
Uruguay Round of the General Agreement on Tariffs and Trade (GATT-UR), xxvii, xxviii, 12, 29

V

value-added tax, expanded VAT, 37
Vienna Convention, 322
Vienna Declaration, 215
Vietnam, 4
Vinluan, Rogelio, 300-302 (comments to Clarete)
voluntary exports restraints (VER), 16
Von Thunen Redux, 450, 459

W

wage agreements, 42
wage and non-wage components, 170
wage orders, 42
wages, 4
welfare analysis of trade, 311
West Germany, 4
white-line appliance industry, 196
women, 219
Work of Nations, The, 59
World Bank Handbook on Liberalizing Trade in Service (1994), 125
World Bank, 58
World Competitiveness Report (WCR), 453, tables, 476-477
World Conference on Human Rights in Vienna, 1993, 214
World Development Report 1980, 27
world economic environment, xxviii, overview, 3-27

World Institute for Development Economics Research (WIDER), 203
World Intellectual Property Organization (WIPO), 276
World Trade Organization Treaty, 391
World Trade Organization (WTO), xxv; xxvii, accession to, xxix, 30, 152, 176, 179, 275, 393, 427-428

Y

Yap, Jose F. and Aleli dela Paz (1990), 364
Yugoslavia, 4

