Trade Liberalisation
in South-East Asia

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Acronyms

ACCSQ  ASEAN Consultative Committee Standards and Quality
AEM  ASEAN Economic Ministers
AFTA  ASEAN Free Trade Area
AIC  ASEAN Industrial Complementation
AICO  ASEAN Industrial Cooperation Scheme
AIDS  Almost Ideal Demand System
AIJV  ASEAN Industrial Joint Venture
AIP  ASEAN Industrial Projects
ANZCERTA Australia-New Zealand Closer Economic Relations Trade Agreement
APEC  Asia-Pacific Economic Cooperation
ASEAN  Association of Southeast Asian Nations
BBC  Brand-to-Brand Complementation
CACM  Central American Common Market
CEPT  Common Effective Preferential Tariff
CER  Closer Economic Relations (ANCZERTA)
CGE  Computable General Equilibrium
CIF  Cost, Insurance, Freight
COMECON  Council for Mutual Economic Assistance
CU  Customs Union
EEA  European Economic Area
EPZ  Export Processing Zone
EU  European Union
FDI  Foreign Direct Investment
FOB  Free on Board
FTA  Free Trade Agreement
GATT  General Agreement on Tariffs and Trade
GDP  Gross Domestic Product
GNP  Gross National Product
GTAP  Global Trade Analysis Project
HCMC  Ho Chi Minh City
HS  Harmonized System
IFPRI  International Food Policy Research Institute
IMF  International Monetary Fund
JV  Joint Venture
MFA  Multifibre Agreement
MFN  Most Favoured Nation
NAFTA  North American Free Trade Agreement
NIE  Newly Industrialised Economies
NTB  Non-Tariff Barriers
Lao PDR  Lao People’s Democratic Republic
PTA  Preferential Trading Arrangement
RIA  Regional Integration Agreement
SAM  Social Accounting Matrix
SGP  System of Generalised Preferences
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<td>SITC</td>
<td>Standard International Trade Classification</td>
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<td>SOE</td>
<td>State Owned Enterprise</td>
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<td>TBT</td>
<td>Technical Barriers to Trade</td>
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<tr>
<td>UNCTAD</td>
<td>United Nations Conference on Trade and Development</td>
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<tr>
<td>UR</td>
<td>Uruguay Round</td>
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<tr>
<td>WCO</td>
<td>World Customs Organization</td>
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<td>WTO</td>
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Executive Summary

The purpose of this paper is to survey trade liberalisation efforts in South East Asia and their reception among trade policy analysts. It also considers the role that the newly entering transition economies are likely to play in the region. Requirements for other policy areas arising from trade liberalisation are discussed as well.

The first chapter starts with an introduction to international trade theory and to the political economy of protectionism. Some considerations on requirements and consequences of trade liberalisation follow. The second chapter summarises past and present efforts of trade liberalisation in South-East Asia: Economic cooperation within ASEAN before the foundation of AFTA, the AFTA plan itself and liberalisation efforts within APEC are considered. The third chapter consists of an overview on the results of studies using CGE-models to explore the probable consequences of trade liberalisation.

While these quantitative studies have not yet included Vietnam, Laos and Cambodia into their experiments, the fourth chapter takes a look at these new entrants within a more qualitative analysis, made difficult by a lack of adequate data. The structure of output and trade directions are reviewed on the background of these countries’ factor endowments, which will shape their role in the regional and global economy in the future. Their present trade policies are reviewed and suggestions are made on how they could be reformed in the light of AFTA and WTO membership.

The fifth chapter takes an outlook on other aspects arising of the AFTA plan: The macro-economic consequences of trade liberalisation in general and regional economic integration in particular are discussed in the light of AFTA. With regard to the newly entering transition economies, in particular Vietnam, the role of state-owned enterprises is reviewed in the context of trade liberalisation.

Chapter 1: International Trade and Developing Countries

Trade offers countries many advantages. The most basic advantage of international trade is that countries can consume goods that cannot be produced locally. However, a more important reason for trade is, that countries differ in terms of efficiency when producing certain goods. Trade allows countries to benefit from their comparative advantage (Ricardo) by focussing on the production of those goods which they can produce more efficiently than other goods and by trading them against goods produced more efficiently elsewhere. Trade is also a reflection of different factor endowments, because each country is likely to produce goods where intensive use is made of those factors which are abundantly available in the country (Heckscher-Ohlin). Presently, trade between developed economies on the one hand and developing economies on the other reflects different factor endowments. This so-called inter-industry trade consists of
exports of labour-intensive or natural-resource-intensive goods from developing to developed economies. Developed economies, in turn, export capital-intensive and skill-intensive goods to developing economies. Trade among developed economies, the so-called intra-industry trade is not based on differing factor endowments but is a result of economies of scale in the production of highly-specialised goods.

Despite the benefits of trade, countries pursue protectionist policies: The unequal distribution of gains from trade between and especially within countries, rent-seeking activities of coalitions that would potentially lose from free trade and transitional problems as a consequence of trade liberalisation have been identified as main reasons for protectionist policies. In developing countries, the infant industry argument is used to justify protection: in the logic of this argument (which also implies a strong bias against agriculture), industrial development outside a country’s comparative advantage shall be fostered behind high walls of protection. Increased experience and higher competitiveness are supposed to result from this protection. Experience has, however, been ambiguous. Other, more recent arguments for protection regard strategic industries which operate in imperfectly competitive markets. Such strategic protection is assumed to make no sense in South East Asia because the underlying assumptions do not (yet) apply to those countries.

While free trade is an economically desirable option, it is politically difficult to achieve due to the unequal distribution of gains. Gains from trade liberalisation can be divided into two categories: Static gains, stemming from more efficient resource allocation in the liberalising economy, and dynamic gains, which consist of increases in economic growth rates. The importance of dynamic gains is increasingly recognised by economists, and studies on trade liberalisation in South-East Asia usually stress that dynamic gains had much larger welfare effects than the traditional static effects.

While developing countries have refused trade liberalisation for decades, preferring strategies of import substitution and infant industry protection along with demanding preferential access to markets of developed economies through the System of Generalised Preferences (SGP), they have recently taken a more active role in trade liberalisation, especially since the GATT Uruguay Round. An important factor in this change of mind is the overall better performance of more open developing economies. Additionally, a shift in perception about foreign direct investment (FDI) has occurred: FDI is increasingly regarded as a way of importing technology and know-how which yields better results than learning by doing behind walls of protection. Since much of this FDI is export-oriented, countries have increasingly opened up their trade regimes, recognising the adverse impact of high import barriers on their capacity of exporting competitively. East Asian and South East Asian countries have made good experience with such export-led growth, reducing poverty tremendously and increasing living standards throughout the region.

The reduction of tariffs and quotas has long been the focus of GATT’s interest. However, tariffs, which were constantly lowered since the 1950s have lost much of their trade-obstructing character and attention in the business of trade liberalisation shifts more towards other, more subtle trade barriers such as technical barriers to trade. It is
clear that progress in liberalisation will increasingly depend on countries’ ability in eliminating these trade barriers, too.

It is, however, necessary to make a difference between two types of liberalisation when assessing their impact: *Non-discriminatory* liberalisation, which consists of a removal of trade barriers on imports from *all* countries is regarded as the first best policy, yielding the largest gains in both static and dynamic terms. Nevertheless, countries in all parts of the world have engaged in *discriminatory* trade liberalisation within trade blocks such as the EU, NAFTA or AFTA. Although discriminatory liberalisation is regarded to yield considerably less gains, it offers some advantages in the context of bargaining, which might partly explain why it has become increasingly popular. This increased popularity has, however, not changed the attitude of economists who continue to regard discriminatory trade liberalisation as a *second best* solution only.

**Chapter 2: Regional Trade Liberalisation in South-East Asia**

South-East Asia’s experience with *discriminatory* liberalisation has been disappointing so far: ASEAN\(^1\) economic cooperation, consisting of a Preferential Trading Arrangement (PTA) (which was meant to increase intraregional trade) and several industrialisation schemes in the tradition of import substitution (which were meant to guarantee an appropriate division of gains from the PTA) have overall been ineffective: The Preferential Trading Arrangement covered mostly goods that were not traded or that were only marginally traded, and safeguard measures hindered that trade would be effectively liberalised. The industrialisation schemes had not enough impetus from the private sector, due to their highly bureaucratic character and their focus on large-scale industrial projects (similar to those usually known from socialist economies) which were not in line with comparative advantage. Moreover, ASEAN economies had no sound economic reason to trade with each other on a large scale, given the similarity of economic structures and factor endowments. While ASEAN’s *political* achievements are remarkable, the best that can be said about its economic co-operation efforts is, that it brought these countries together and provided them with experience regarding the trade liberalisation business.

In the early 1990s, the then European Community was deepening its integration with the completion of the common market and the ratification of the Maastricht Treaty, while the US, Canada and Mexico agreed on the establishment of the North American Free Trade Area (NAFTA). At the same time, progress in the GATT Uruguay Round was extremely slow and a positive outcome of these multilateral trade negotiations was all but certain. These two trends in international trade - growing regionalism and weakening efforts in the multilateral framework - were *push factors* for ASEAN countries’ decision to increase regional economic co-operation by establishing AFTA,

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\(^1\) ASEAN consists of Brunei Darussalam, Indonesia, Malaysia, The Philippines, Singapore, Thailand and Vietnam (which entered only on 1 July 1995).
the ASEAN Free Trade Agreement. The cornerstone is the Agreement on the Common Effective Preferential Tariff (CEPT) which aims at free trade between ASEAN member countries by 2003 (after initial plans had targeted 2008). “Free trade” in the sense of AFTA means a reduction of tariff rates to between 0% and 5% on all manufactures and most agricultural goods. Tariff reductions under the CEPT, which also requires the removal of Non-Tariff Barriers (NTBs), have already started and attention is now shifting to other trade barriers.

AFTA countries have increasingly become involved in the harmonisation of customs procedures. They have agreed to gradually introduce the WTO’s procedures for customs valuation and to use the same version of the harmonised system. Co-operation in the areas of technical standards and certification has started, too, and the possibility of setting up a regional patent and trademark system is presently being explored. In addition to this, a new scheme on industrial co-operation (AICO) has recently been set up. It proves that ASEAN member countries have learnt from past experience, because the new system seems to be considerably less bureaucratic but more market-oriented.

The reception of the AFTA plans in economic literature has not been very positive so far. Observers tend to judge AFTA by the experience with the ASEAN PTA. Most doubt is on whether the scheme will lead to true liberalisation, because AFTA is institutionally weak, and member countries are still reluctant about transferring sovereignty rights to a supranational body. With regard to the still low intra-regional trade share, many observers also have doubts regarding the economic need for such a free trade area between similar economies. There is widespread agreement, that ASEAN countries get their economic impulses much more from extra-regional markets. Some argue that AFTA will only lead to trade diversion with adverse effect on members’ prosperity.

AFTA has not been the only initiative for trade liberalisation in the region. Member countries\(^2\) of APEC (Asia-Pacific Co-operation) have agreed to establish free trade in the region by the year 2010 (developed countries), respectively 2020 (developing economies). The group has emerged from informal contacts, originally between business leaders and academics in the region, which have promoted to the ministerial level in the late 1980s and early 1990s. APEC is, unlike AFTA, not a free trade agreement in the sense of Article XXIV GATT but it perceives itself as an open economic association.

Contrary to AFTA, APEC has got a warm welcome in literature. Since the region will undoubtedly become the gravity centre of growth and world trade in the coming decades, the risk for trade diversion within such a large and heterogenous area is considered as low, compared to AFTA. The openness of the group has also been welcome by most analysts. In my opinion, however, APEC, as it is now, does not (yet) justify great expectations: Views on the grouping’s future diverge considerably between

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\(^2\) APEC members are Australia, Brunei Darussalam, Canada, Chile, China, Hong Kong, Indonesia, Japan, South Korea, Malaysia, Mexico, New Zealand, Papua New Guinea, The Philippines, Singapore, Taiwan, Thailand and the USA.
member countries, especially between the United States and the culturally different Asian countries (some of which might even favour a co-operation area without the US as a partner). Additionally, present members are highly heterogenous and, at the present stage, are better known for their tense trade relations (US-Japan, US-China) and other regional disputes (Taiwan-China, Spratleys) than for very harmonic relations. Despite the desire to co-operate, the high intra-regional trade shares and the impressing growth rates (which might make some economists blind for other less economic problems), APEC has still a long way to go.

Chapter 3: The Impact of Trade Liberalisation on South-East Asia: Empirical Findings

The issue of trade liberalisation in South East Asia has attracted increasing interest from policy analysts and some considerable work has been carried out on this subject. Despite the differences between individual studies, the conclusions are basically the same throughout the work accomplished so far: The AFTA plan, aiming at the establishment of a discriminatory free trade arrangement between competitive (in the sense of similar) countries is viewed with suspicion. For all ASEAN3 countries (except Singapore), free trade along the larger APEC lines is expected to yield much larger gains in terms of economic growth. All studies regard non-discriminatory liberalisation along WTO lines as the first best policy while some disagreement arises only on whether reciprocity should be required from the rest of the world. Free trade is expected to result in a shift in the structure of output. Sectors within the comparative advantage of countries are expected to increase production (and exports) and to attract production factors out of less competitive sectors.

As far as the size of an integration area is concerned, gains increase along with the number of countries that participate in liberalisation. The exclusion of an economy makes all countries worse off but hits the excluded economy most. The range of products which are to be liberalised should be as wide as possible. Concerted, simultaneous liberalisation is regarded as superior to unconcerted liberalisation, because the former leads to less pronounced terms of trade effects.

In general, ASEAN countries are considered to be among the principal winners from free trade along the lines of APEC or the WTO. Especially the large and so far more protectionist ASEAN countries are supposed to gain substantially. Considerable gains are also expected from the phasing-out of the Multifibre Agreement. While Singapore is expected to win more from discriminatory liberalisation, she is expected to lose from non-discriminatory liberalisation, because she might lose some of her retail functions in the region, which are the result of the present trade diversion. However, if dynamic effects are considered, too, substantial gains from liberalisation in the region should accrue to Singapore as well - especially because this type of gains is considered to be

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3 Brunei Darussalam and the newly entered Vietnam have not been included in most studies.
most pronounced in rich agglomerations. But as has already been mentioned above, dynamic gains are generally expected to be much larger than purely static gains.

Chapter 4: AFTA and the New Entrants

With the end of the Cold War, ASEAN has finally the chance of becoming a truly regional arrangement. Vietnam was the first of the formerly socialist countries to join ASEAN in July 1995, and it has started trade liberalisation within AFTA at the beginning of 1996, aiming at the completion of free trade in 2006. Cambodia and Laos are scheduled to become ASEAN members in 1997, but it is not yet sure when these countries, especially Laos, will be ready to start with the liberalisation process.

Assessing the actual impact that AFTA membership will have on these three newly entering transition economies is a difficult task. Due to the deep restructuring process which came after transition from the planned economy to the market economy, only a short track of economic data is available which allows to make predictions for the future. As far as trade data are concerned, predictions become even more difficult, because the unofficial portions of cross-border trade are not captured in any statistics but are certainly no less important for the determination of comparative advantage than official trade data. The lack of the most basic infrastructures in Laos and Cambodia for trade at adequate transaction costs and the only recent return to peace of the latter make assessments of their trade potentials even more difficult.

Nevertheless, considering some basic information on factor endowments shows that Vietnam is very well endowed with human capital. Cambodia and Laos are less endowed with human capital but natural resources are more abundant. These two countries, however, will have to make considerable efforts in human capital development; illiteracy is still high, but even primary resource based production (and trade) such as agriculture and logging require high skills nowadays, given the sensitive ecosystems and the capital goods character of trees (logging) which will play a key role in Cambodian and Lao foreign trade.

While agriculture constitutes still around one half of GDP in Laos and Cambodia, Vietnam already has a higher share of industry, which contributes nearly one third to GDP.

The directions of trade of ASEAN countries still reflect the relatively low intra-regional trade shares, mentioned by many critical observers who say AFTA will mostly create trade diversion because there are no overwhelming reasons for intra-regional trade. However, it is interesting to see that Laos and Cambodia trade a lot with other countries in the region - even without considering the smuggling that occurs across the relatively open borders. At the same time, all three new entrants are characterised by low trade shares with industrial countries. These findings can clearly be interpreted as a higher complementarity in economic structures between new entrants and original ASEAN members than among original ASEAN members who have mostly low intra-regional trade shares. Given their very low stage of development, the three new entrants can trade...
on an inter-industry-basis with the more developed original ASEAN members, where development leads to structural adjustment attracting production factors partly out of primary and low-skilled-labour

The new entrants may become preferential production bases for labour-intensive industries with growing wages in other ASEAN countries. Thus, the relationship between original and newly entering ASEAN members will be determined by partly competitive structures (all countries are still major exporters of labour-intensive goods) and partly complementary structures.

In the case of Laos, the country will have to make enormous efforts in infrastructure development if it is to have its share in the gains from trade liberalisation, because competitiveness in trade requires a minimum of satisfactory road and rail links with other countries - especially in absence of direct access to the most inexpensive form of transport which is by sea.

Reforms of the trade regimes have been under way in all new AFTA members over the last few years. Vietnam has been the most active country when it comes to trade liberalisation and integration into the world economy. It has been the first country to become a member of AFTA and it has applied for WTO membership, as did Cambodia. Vietnam is also a member of the World Customs Organisation. Laos is lagging behind in the trade liberalisation process, partly due to the lack of trained, English-speaking personnel.

Vietnam has liberalised its trade regime to a considerable degree, but imperfections remain such as quantitative restrictions and licensing requirements. Moreover, the trade regime has maintained a highly discretionary character with frequent changes in tariff rates and considerable dispersion, which both facilitate targeted lobbying for protection. Some import quotas and permits remain and occur remarkably frequently in sectors where state-owned enterprises are producing.

It may be questionable whether AFTA can change Vietnam’s discretionary trade policy, given the former’s yet weak institutional structure. However, if Vietnam respects its obligations under the AFTA treaty, it will have to phase out its quantitative restrictions at least on the intra-regional portions of trade. WTO membership, however, will likely impose more discipline on the country.

Cambodia has undertaken impressive reforms of its trade system. The tariff code is streamlined, compared to that of Vietnam, and contains only four dominant rates. Although tariffs are the most important source of government revenue, the country can be characterised as relatively open. However, there is still scope for additional reform: The present treatment of re-exports by customs authorities does not necessarily reflect international practice in this area. The country is presently flirting with an increased used of export taxes as a means of trade, environmental and industrial policy. These reforms, however, could endanger the country’s development opportunities.
The Lao trade regime has been freed from most restrictions, too. The country has a transparent tariff structure with six main rates and a few exceptional rates for special goods, which will be transformed into excise taxes in early 1997. The country has adopted the GATT valuation rules for imports, too. Shortcomings of the Lao trade system are the lack of duty drawbacks for exporters who export only a part of their production, and the organisational shortcomings of the Lao Customs Administration.

Chapter 5: Policy Implications of Trade Liberalisation in South-East Asia

Trade liberalisation has a strong impact on macro-economic policies. A loss of tariff revenue for government budgets and an increase in imports, leading to balance of payment problems with likely pressures on the exchange rates of the liberalising economy may arise for a liberalising country. In the case of Laos an Cambodia, the impact on government revenue is likely to be more pronounced than in other countries, because the share of international trade taxes in government revenue is high and the portion of imports subject to liberalisation is considerable, too.

Countries have various options to accompany trade liberalisation; as far as the loss of tariff revenue is concerned, tax reforms and privatisations might provide some additional revenue. Cuts in government spending might be an option as well. As far as the external balance is concerned, increasing inflows of foreign direct investment could compensate higher imports of goods and would be a good alternative to foreign debt. Increased savings would reduce the propensity towards consumption and could therefore partly reduce import demand as well. Last but not least, higher exports can also finance higher imports, and chances for an increase in exports are good: Import duties often have a strong anti-export bias and trade liberalisation therefore helps exports to become more competitive as well. It becomes clear, that these policy responses include in most cases the creation of incentives arising from adequate legal frameworks (property rights etc.). Exchange rate devaluations should be avoided as far as possible, because stable exchange rates offer many advantages, and exchange rate instability may increase pressures to reverse liberalisation again.

Discriminatory trade liberalisation within a trade bloc such as AFTA has some additional features. In a trade bloc, the economic interdependence between member countries grows along with trade. Increased trade requires some growth of funds and therefore, macro-economic co-operation between member countries becomes necessary.

As intra-regional trade grows, the financial sector develops, too, because increased trade in goods needs to be accompanied by better infrastructure for international financial transactions. Better financial infrastructures increase the mobility of capital and therefore limit the efficiency of uncoordinated national macro policies. Ironically, a country that wishes to keep some sovereignty therefore needs to co-ordinate its macro policies with the other members because only co-ordinated policies can bring the desired results. AFTA, however, has not established rules so far for macro-economic co-operation. So far, it has no plan for the harmonisation of taxes either. Co-ordination in
these areas, however, will become necessary, once AFTA reaches a certain degree of market integration.

Pure co-ordination of such policies, however, may not be enough. In the case of monetary policies, some discipline is required as well, and this is best achieved if central banks are independent or if their are well-defined rules that countries have to respect.

Problems arising from the AFTA plan could be macro-economic imbalances, high and variable inflation rates, exchange rate misalignments, losses of fiscal revenue, an unbalanced distribution of costs and benefits of liberalisation and the absence of adequate institutions.

With regards to the new entrants and especially Vietnam, it is interesting to check the links between state enterprise policies and trade policies. State-owned enterprises (SOEs) often produce in sectors that are not in line with comparative advantage. Trade liberalisation would harm these sectors, and present high tariff protection in sectors, where SOEs operate, can be a sign that these SOEs would not necessarily survive in a free trade system.

This creates problems for policy makers who want to pursue both trade liberalisation and privatisation. If producer rents of SOEs arising from protection are eliminated, the readiness of potential investors to invest into the firms decreases, because their expectations about the rate of return of investment get worse. If, however, the country does not liberalise its trade regime, it is likely to foster iron triangles (coalitions of potential losers from free trade), which may endanger future steps towards liberalisation considerably.

The issue of state enterprises should, however, be regarded in the broader context of the general desirability of SOEs. Looking at this issue from that point of view would clearly call for the privatisation of all SOEs that do not operate under cost structures that lead to natural monopolies. Further on, a government which administers a huge stock of SOEs has to pursue conflicting interests, due to its role as a regulator (which would be the task it should really focus on) and its role as entrepreneur. And although AFTA contains no provisions on industrial policy, subsidies or state intervention, other member countries are unlikely to tolerate it if one member pursues industrial policies by holding a large stock of SOEs - unless these SOEs have to operate under the same market conditions as industries in other, more market-oriented member countries.
1 International Trade and Developing Countries

1.1 Reasons for International Trade

Countries have good reasons to exchange goods through international trade. Economic theory provides some explanations for international trade. One of the most basic reasons for trade is that it enlarges a country’s possibilities of consumption, providing it with goods that cannot be produced locally, for example coffee in Norway. But there is also substantial trade in goods that could be produced in any country, suggesting that some countries can produce certain goods more efficiently than others. This idea was incorporated in the Ricardian theory of comparative advantage.

Often, trade also reflects the factor endowments of a country. Each national economy is likely to produce goods whose production is intensive in the use of resources of which the country has a relatively abundant supply. The Heckscher-Ohlin theory incorporates this idea. We might conclude from this that countries with similar factor endowments and therefore a similar structure of output (“competitive structures”) might have less incentives to trade with each other than countries with different factor endowments (“complementary structures”).

However, even countries with similar factor endowments trade with each other. But this type of trade - the so-called intra-industry trade, which is international trade within the same sector - occurs most between developed economies, due to their high degree of specialisation and economies of scale. Trade of developing countries is rarely intra-industry trade but mostly inter-industry trade with developed economies: Some sectors are exporting (for instance labor-intensive sectors such as textiles and apparel) while others are importing (for instance capital-intensive sectors such as machinery and equipment), reflecting comparative advantage and factor endowments.4

1.2 Protectionism: A Political Economy and New Developments

Although there is widespread agreement among economists on the beneficial effect that trade has on countries, trade barriers in the real world are still high. In most cases, the unequal distribution of gains - within countries more than between countries - is the reason for countries’ reluctance to pursue free trade policies. Theory suggests that international trade is beneficial to trading economies, allowing their consumers and producers to buy the most efficiently produced goods and inputs at the

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lowest costs. Nonetheless, the world is full of barriers that obstruct trade and force consumers to buy higher price domestically produced goods.

The reason for this contradictory situation is that the opening of a country to trade leads to the redistribution of income within countries. The specific factor model, developed by Samuelson and Jones, shows that factors specific to import-competing sectors lose while factors specific to exports sectors gain from trade. Although the gains from trade would principally be sufficient to compensate the losing factors, loser coalitions have identified targeted lobbying for protection as a more reliable way of cementing the status quo.

The size of groups that lose from free trade is often small, compared to the size of groups that would potentially gain. In the case of heavily protected agricultural markets in developed economies, for instance, the potentially losing farmers are a small group compared to the large group of consumers, who would reap the benefits of more open markets. This implies, however, that the losses that occur to every member of the loser coalition are by far larger than the benefits that occur to the individual winners. While this is a strong incentive for the losers to gather and to lobby for continuing protection (rent-seeking), the potential winners, given their larger number, will have less incentives to struggle for open markets, partly due to a free rider phenomenon since individual gains are too small to provide an incentive for action. Moreover, since larger groups are usually less organised, small groups can have greater success in making their voice heard.

National bureaucracies have incentives to oppose liberalisation and to build up an effective coalition with other potential losers. Especially in the case of NTBs such as quotas, bureaucrats have often achieved considerable power and privileges through their role in administering trade. They are concerned about losing these privileges - which in the worst case even include the financial participation (via corruption) in the rents that a licensed importer “earns” - and therefore firmly oppose free trade.

In the end, protection may lead to iron triangles, which are linkages between protected firms, organised labour in protected sectors and government officials. These iron triangles can often successfully prevent any liberalisation.

Trade liberalisation would often entail transitional costs such as balance of payment problems or unemployment caused by layoffs in internationally uncompetitive sectors. Governments of protectionist countries are afraid of the transitional costs of liberalisation. These costs include balance of payments problems as well as transitional unemployment. Balance of payment problems may arise as a consequence of liberalisation because the substitution of domestically produced goods by more imports requires exchange rate adjustments: the currency has to devalue in order to promote

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7 The macroeconomic consequences of trade liberalisation are explained in detail in section 5.2.
exports which provide the income needed to finance the higher imports. These currency devaluations, however, are unpopular - especially in countries facing inflationary pressures.

Transitional unemployment is likely to occur if salaries in the protected domestic sector are higher than in the same sector abroad. In order to keep unemployment down, real wages would have to adjust, some times substantially, to a lower level. Since this is not only unpopular but often impossible - at least in the short run when wages are fixed in contracts between employers and unions - unemployment will unavoidably rise. Such transitional costs may have a higher weight in the considerations of policymakers than long term gains, because these costs occur in the short run and can endanger the political survival of policymakers, while long term gains may be politically less remunerating. This explains to a certain extent why protectionist policies are pursued despite the findings of empirical studies which point to the welfare improving character of free trade, but do not take transitional costs and the path of adjustment into account (cf. chapter 3).

Freer trade can also adversely affect the terms of trade: The lower after-customs price of a good can lead to higher demand which, in turn, can increase the price of the imported product, worsening the country’s terms of trade.

As a general rule of thumb, we can say: The larger initial distortions through restrictive import policies are, the larger are the effects of trade liberalisation. This applies to the adjustment costs in the short run as well as to the beneficial effects in the long run.

Potential market failure can deliver a few acceptable arguments for protection but often, trade policy is not the first best policy to tackle these issues. The few intellectually acceptable arguments for protection are based on a common concept, arguing that the domestic economy is subject to market failure. These specific types of market failure consist of distortions of factor markets in developing countries (especially the large differential between urban and rural wages with persisting urban unemployment) and possible spillovers from learning by doing - the old infant industry argument (later). However, both issues can be tackled better by policies addressing the issues directly than via trade policy.

The heavily debated infant-industry argument gives another reason for protectionism. It has served for decades to explain why developing countries might be better of protecting their industries than by a premature liberalisation of their trade regimes. It was (and still is) feared that industries of countries, which lag behind in terms of development, may be dominated by industries in more developed countries. These latter may be interested in preventing learning effects in the former, thus perpetuating their

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dominance and, along with it, the differences between countries’ development. This may ultimately increase the polarisation instead of closing the gap.  

**New strategic arguments for protection make some sense but the underlying assumptions do not apply to developing countries.** Recently, a new argument has come up: imperfect competition and increasing returns to scale would give governments strategic functions in supporting their industries; for instance, a preannounced export subsidy could deter foreign competitors from producing more while the benefits to the subsidising economy (at foreign expense) would be larger than the subsidy itself. However, the assumptions underlying this theory (the country producing the good of an imperfectly competitive market should be a major supplier of this good, and the country itself should be a substantial part of the world market) do not apply to developing economies.

*Krugman* discusses two other arguments. The first is, that protection can induce suppliers of imperfectly competitive products to sell them more cheaply while the second is, that entry into some industries might yield rents to specific factors, even if monopoly profits are competed away. In the sense of this argument, export promotion might raise the countries income. These arguments are, however, unimportant, compared with the infant industry argument.  

**Protection imposes high costs on the protecting economy and even taxes exports indirectly.** Protection entails enormous costs for national economies. The welfare losses caused by protection consist mainly of a producer distortion loss, arising from stimulating costly domestic production of goods that could be cheaply imported. Another loss arises from consumer distortion because consumers shift away from cheaper imports and pay a higher price for the goods.

Further on, import protection tends to create balance of payment surpluses, resulting in higher exchange rates, which in turn make the country’s exports more expensive and therefore less competitive, and reduce the effective protection for the import sector. Both sectors end up with higher costs in term of foreign currency. Estimates suggest that every percentage point of taxation of imports thus becomes a tax of between 0.4 and 0.8% on exports.

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9 However, attention has shifted away from the infant-industry argument for some time already, and scientists as well as policymakers now perceive economic openness as the panacea against underdevelopment.


1.3 Trade Liberalisation

1.3.1 Effects of Trade Liberalisation

Free trade is economically desirable but politically hard to achieve. Given the overall welfare-improving effects of free trade on the one side and the unequal distribution of gains or the transitional problems on the other side, pursuing free trade strategies is in many cases politically unviable and trade barriers can be lowered only in often lengthy and exhausting negotiations between countries, following the do ut des rationale because many divergent interests need to be taken into account. Through concerted liberalisation among a number of countries, firms get compensated for higher competition on domestic markets by better access to export markets. Besides, negative terms of trade effects are less pronounced in the case of concerted liberalisation.

Trade liberalisation has static and dynamic effects. Static gains result from resource reallocation and the substitution of high cost domestic products by more efficiently produced imports. There are substantial incentives for policy makers to liberalise trade. The effects of trade liberalisation can be divided into two groups, namely static and dynamic effects. Generally speaking, static gains arise from the replacement of high cost domestic goods with more efficiently produced foreign goods.

In the context of discriminatory liberalisation, however, we distinguish two types of static effects which make the outcome of this type of liberalisation ambiguous: trade creation and trade diversion. Trade creation consists of the shift in demand away from more expensive, domestically produced goods to lower cost products from FTA members. Trade creation increases welfare because it yields efficiency gains.

Trade diversion occurs instead, when demand shifts from lower cost third country products to higher cost products from FTA member countries, because the latter become cheaper to customers on the domestic market due to the removal of the tariff. After the creation of the FTA, the importing country may have to spend a higher proportion of its export earnings on the imported good, because demand for the high cost imported good increases (since it becomes cheaper to the customers) while the cost of the product for the country as a whole is higher than that of the third country import, due to the higher supplier price. This effect can even be reinforced if the increase in demand of the importing country is strong enough to lead to an increase of the price of the imported good. Moreover, the tax that had been paid by customers before the FTA on the lower cost third country import on account of the tariff constituted government revenue and as

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12 cf. Martin, Will/Yanagishima, Koji: Concerted Trade Liberalisation, 1995, p. 5-8
13 The two concepts of trade creation and trade diversion were introduced by Jacob Viner in the context of the customs union; see also Lewis, Jeffrey D./Robinson, Sherman/Wang, Zhi: Uruguay Round, 1995, p. 23f.
such was not a net cost to the importing country.\textsuperscript{14} Trade diversion usually decreases welfare.

Whether discriminatory liberalisation within a FTA is beneficial to the participants depends on the relative size of the trade creating and the trade diverting effect. If trade creation prevails, the FTA has beneficial effects on member states.

\textit{Dynamic effects increase growth rates of liberalising economies.} Larger markets permit a greater degree of specialisation, thus leading to cost reductions and more competitiveness. This argument is particularly convincing in the presence of economies of scale or in the case that diverging product standards are unified.

Other explanations include higher incentives to investment in research and development in larger markets, the availability of a range of specialised, domestically not available inputs and gains from learning by doing.\textsuperscript{15} Further on, external effects can arise from free trade, since specialisation and international co-operation might lead to technological spillovers, reducing costs of innovation and enhancing technological change to the benefit of customers and the industry’s competitiveness.

\subsection*{1.3.2 Multilateralism versus Regionalism}

\textit{Trade liberalisation currently takes place on two levels: the World Trade Organisation (WTO), successor of the General Agreement on Tariffs and Trade (GATT), co-ordinates the efforts to liberalise trade on a world-wide, multilateral level, while on the regional level, arrangements such as ASEAN/AFTA or the EU/EEA aim at trade liberalisation within their regions. Although WTO-style liberalisation is economically the first best solution, the advantage of regional arrangements lies in the negotiatory context.} The principles of multilateral trade liberalisation, undertaken by the WTO, are essentially non-discriminatory treatment and reciprocity. Non-discriminatory treatment (or application of the Most Favoured Nation (MFN) Principle) means that a country that lowers its tariffs on imports from another country should extend this preferential treatment automatically to all other WTO member countries.\textsuperscript{16}

The idea of reciprocity means that a country that benefits from easier access to another country’s market should equally lower its tariffs for the latter’s imports. Ideally, every unilateral step towards liberalisation would become a multilateral step through the MFN and reciprocity principles.


\textsuperscript{15} For a survey of gains from trade with further references, cf. Martin, Will/Yanagishina, Koji: Concerted Trade Liberalisation, 1995, p.5-8.

\textsuperscript{16} Article I of the GATT.
Among GATT instruments, the most notable are tariff bindings\textsuperscript{17} and the obligation of national treatment, forbidding differential treatment of domestic products on the one hand, and imported products on the other hand, in fields such as taxation, sales regulations etc.\textsuperscript{18}

There is, however, one important exception to the obligation of MFN treatment. Article XXIV GATT specifies that countries can grant each other additional concessions if they intend to establish a preferential trading arrangement. The requirements for such agreements are, however, high: The import restrictions of a customs union, for instance, shall not be higher than the incidence of the restrictions that had been applied before the formation of the CU\textsuperscript{19}. Another clause requires that preferential treatment must be granted to substantially all trade.\textsuperscript{20}

Although economists generally agree on the fact that global liberalisation has superior results to regional liberalisation, regional blocs are a current phenomenon in world trade reality. Among other reasons such as geographic proximity or cultural-historical linkages, one important cause for the existence of regional blocs is that they offer advantages in the negotiatory context: The conclusion of a regional agreement offers exclusive trade creation to the partner country through trade diversion, away from former third country suppliers. In larger areas (or on the global level), the advantage that these preferences offer tends to erode.\textsuperscript{21}

\textbf{In world trade reality, two types of preferential arrangements are common: the free trade area (FTA) and the customs union (CU).} In the FTA, member countries abolish tariffs on imports originating in other member countries, but each country maintains its own foreign trade regime on imports from third countries. In the CU, member states also abolish tariffs on imports from each other, but additionally agree on a common external tariff; this means that the same tariff is imposed on third country imports by all members of the customs union.

\textbf{Rules of origin are a crucial determinant of the success of a FTA.} The difference between a FTA and a CU has far-reaching implications. First, member countries of a free trade area need to agree on a set of rules of origin for trade with each other. These

\textsuperscript{17} Tariff bindings are formal commitments of countries to keep their import duties below certain levels. These should reduce uncertainties for exporters about applied tariffs and should prevent a country from increasing its level of protection. Tariff bindings must be seen in the light of another objective, which is the removal of all NTBs by more transparent (bound) tariffs; cf. World Bank: World Development Report, 1987, p. 156 and Croome, John: WTO Obligations, 1996, p.5).

\textsuperscript{18} For an introduction to the GATT system, cf. Croome, John: WTO Obligations, 1996.


\textsuperscript{20} It is widely accepted that this requirement is met if 80\% of all trade is covered under the preferential agreement. cf. Croome, John: WTO Obligations, 1996, p. 10.

\textsuperscript{21} This is surely one reason for the only lukewarm support of the Mediterranean EU members regarding the efforts of the Eastern European countries to become members of the European Union - especially with regard to agriculture.
rules of origin determine whether a product originates in a member country and whether it thus qualifies for preferential treatment. While the determination of the origin is easy in trade with goods that were completely produced within one country, this task becomes more difficult, in case that parts come from different countries or in case the good has been manufactured in several countries. In a FTA, free trade applies only to goods with the origin of a member country. Without such rules of origin, third country products could enter the FTA through the member country with the most liberal import regime and then circulate freely within the FTA, thus undermining the tariff regime of the true country of destination. For the same reason, members of a FTA - unlike those of a CU - cannot abolish border controls between each other. Border controls rules of origin are the price that FTA member countries have to pay in order to keep their sovereignty on trade policy towards third countries.

In times of “borderless factories”, these rules of origin have a large impact on the potentials of such free trade areas and their attractiveness for foreign direct investment (FDI). Technical aspects like the possibilities of cumulating minor transformations carried out in different member (and non-member) countries when determining the origin of goods or the treatment of transformations carried out outside the FTA for which the goods have been temporarily exported determine how liberal these rules are and to what degree they allow investors to base their locating decisions regarding production facilities on sound economic considerations.

These rules of origin can create inefficiencies. For instance, Switzerland is linked with the European Union through a FTA from 1972. Because Switzerland is not a member of the European Union, Swiss products need to have either Swiss or EU origin in order to enter the EU free of tariffs. This induces many producers, especially small and medium enterprises who are less experienced with the often complicated rules of origin, to buy parts and ingredients in the European Union or in Switzerland - even if they could get them cheaper in a third country - because they are afraid of losing the Swiss/EU origin. Multinational enterprises are in a special situation regarding these rules of origin. On the one hand, they often locate successive steps of production in different countries and therefore rely on liberal rules of origin, especially since the character of FDI has changed (cf. Section 1.3.3). On the other hand, they are more able to influence the price of goods exchanged between their subsidiaries to a certain extent by transfer pricing in order to comply with rules of origin.

The rules of origin issue is of high importance for AFTA, because Singapore is a virtual free trade country with very low tariffs or zero tariffs, while most other member countries, apart from Brunei and Malaysia, have quite high external tariffs. Concerns

22 The case is different for trade within a customs union; in a CU, goods circulate freely once they have entered a member state and the common tariff has been paid.


24 These possibilities, however, are limited because customs valuation can occur using different measures than the transaction price if exporter and importer are related; cf. GATT: Agreement on Implementation of Article VII of the General Agreement on Tariffs and Trade.
have been voiced, that Singapore might be used as a loophole to enter the AFTA markets.\textsuperscript{25} The relevance of these concerns becomes obvious if we consider that Singapore is the country where most intraregional trade goes to or comes from - while, once more, a considerable part of this trade is entrepôt trade in goods on their way to or from other regions. Next, AFTA has very liberal and relatively simple rules of origin, requiring only 40\% of ASEAN content.

Of course, different conclusions are possible: On the one hand, we could argue that economically desirable free trade between the more protectionist countries and the rest of the world is introduced to a seizable extent through the back door of Singapore.

On the other hand, however, the desire of the more protectionist countries to maintain individual and, in whatever sense efficient, tariff regimes should be respected. Nonetheless, these countries should consider that they run the risk that notable assembly activities of products, which are destined to the four larger ASEAN countries, might be diverted to Singapore in order to circumvent high tariffs. Aware of these risks, they should either liberalise their trade regimes towards third countries as well - the economically desirable solution - or insist on efficient rules of origin that do not undermine their sovereignty regarding foreign trade policy.\textsuperscript{26}

\textbf{1.3.3 Trade Liberalisation in Developing Countries: The Case of South-East Asia}

\textit{Developing countries have only recently assumed a more active role in world trade liberalisation after decades of infant industry protection.} The various rounds of GATT negotiations that took place after World War II have brought tariffs down considerably in trade between developed economies. Developing countries, however, have maintained high tariffs as a remainder of the Sixties and Seventies development policies. Policies of that time aimed at development through import substitution: Behind high walls of protection, industries should have the chance to develop and to become competitive (learning by doing):

In addition to this controversial protection under the so-called \textit{baby or infant industry argument}, restrictive regulations were in force concerning foreign investment, limiting foreign ownership and the repatriation of earnings.

While in some developing countries such as South Korea, this infant industry protection seems to have worked, it posed serious disincentives to trade and investment in others.

On the other hand, developed countries agreed to grant developing economies easier access to their markets within the Generalised System of Preferences (GSP) without


\textsuperscript{26} Presently, a proposal to introduce a substantial transformation requirement is being studied; cf ASEAN: Joint Press Statement, 1994.
requiring reciprocity. But the success of these concessions was limited.\textsuperscript{27} Only recently, especially during the Uruguay Round, developing countries have also started to lower their tariffs and to participate more actively in the negotiations.

\textbf{A change in perception about the best path to development, and the new role of FDI in a globalising world are responsible of the shift from protectionist to more open policies.} The role of FDI has changed in recent years: it shifted away from the establishment of local subsidiaries to serve local markets, towards the establishment of borderless factories with global assembly and marketing concepts, aiming at the exploitation of differences in factor endowments and factor prices across the world. This globalisation has been facilitated by innovations in the telecommunications sector, where more information can be transferred at lower costs over ever growing distances, and the movement towards free market systems and more open trading systems in developing countries, especially in East-Asia. Empirical studies confirm that there is a relationship between outward orientation and growth and that outward-oriented economies have shown superior economic performance than those who chose the path of import substitution.\textsuperscript{28}

FDI is the driving force behind this globalisation and provides developing countries with inflows of capital and industrial know-how. FDI, based on sound economic considerations, is a better path to development than forced bureaucratic national industrialisation efforts. Protective measures such as high tariff rates, selective import bans, high local-content requirements, mandatory use of locally produced parts, foreign-exchange-earning requirements and restrictions on foreign equity holdings which are based on the infant-industry argument are made to deter investors, leaving countries without the positive externalities associated with FDI.\textsuperscript{29}

The present climate of economic growth throughout South-East Asia would provide a good opportunity to liberalise trade from the protectionist remainders of former decades. Developing countries that presently protect domestic producers from competition would be well-advised to lower their obstacles to foreign trade before producer rents get higher as these create additional pressure to keep trade barriers up, to the detriment of the country’s economic well-being.\textsuperscript{30}

\textbf{Countries can liberalise their trade on a MFN basis or within a trade bloc.}\textsuperscript{31} The former usually yields larger benefits than the latter. Liberalisation under the MFN

\textsuperscript{27} The limited success of the GSP is due to several facts; first, it covers only a limited range of products and crucial items such as textiles are excluded. Second, SGP preferences are not “bound” but can be withdrawn or altered. Therefore, exporters limit their exports in fear of import restrictions; cf. World Bank: World Development Report, 1987, p. 167.


\textsuperscript{29} cf. The World Bank, Liberalization, 1994, p. 30.


\textsuperscript{31} cf. The World Bank, Liberalization, 1994, p. XII
model means that the lowered tariffs apply to all exporting countries. This liberalisation is called *unilateral* if one country liberalises without co-ordinating his efforts with other countries or *concerted* if a number of countries liberalise their trade regimes simultaneously. Both ways of liberalisation conform strictly to the GATT, while concerted liberalisation will have more favourable terms of trade effects since imports increase not just in one economy, which then suffers from worsening terms of trade, but also in other economies leading to a more balanced outcome. In addition to this, unilateral liberalisation, however beneficial it would be to the liberalising economy, is politically unviable and often regarded as a gift benefiting foreign countries more than the liberalising country.

The way of concerted, non-discriminatory liberalisation is most promising to East-Asian economies - in static terms, with lower production costs and lower prices for consumer goods, as well as in dynamic terms, with greater productivity and more specialisation. Further, it will attract more FDI which helps to overcome adjustment problems.

*In the case of South East Asia, discriminatory liberalisation would yield considerably less gains than non-discriminatory liberalisation. More generally, the discussion of discriminatory liberalisation can never be more than the discussion of second best solutions.*

It is difficult to predict in which cases a bloc tends to create trade and in which cases it tends to divert trade. Theoretically, strong economic linkages even before the trade bloc comes into being can be a sign of efficient division of labour within the area that could be enhanced by lower tariff barriers. The prevalent effect, therefore, would be trade creation. Another indication for a potentially trade creating regional arrangement can be seen in high initial tariffs and the removal of inefficient home industries as an adjustment following liberalisation. Trade diversion may be prevalent, if effective protection rates on goods from within the bloc become much lower than effective protection rates on third country imports.

Even in the presence of similar initial endowments - like those found within the European Union - regionalisation has proved to be trade creating, partly because considerable intra-industry trade was created, based on economies of scale.

Discriminatory liberalisation within a trade bloc in South East Asia will offer less to Asian countries than MFN liberalisation. Especially in the case of developing countries with similar economic structures, discriminatory liberalisation has at best little impact or, worse, diverts import trade away from low-cost third country producers to high-cost producers within the bloc. This is especially true if the trade bloc is relatively small, like ASEAN/AFTA where member countries - except Singapore - have competitive (in the sense of similar) production structures.

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Within a larger bloc, for instance along APEC lines, beneficial effects would be stronger, given the larger size of the area (economies of scale) and the greater differences between member countries and their production structures. However, even in a larger arrangement, the discriminatory character inherent to any trade bloc can lead to welfare-reducing trade diversions.\textsuperscript{35}

The determination of an optimum integration area is a difficult task. The research on the optimum size of an integration area has not yet been very intensive because economists prefer to study the first best solution (which is global liberalisation) instead of “wasting time” on the second best discriminatory areas which, however, have more relevance in the real world. Tichy\textsuperscript{36} studied the criteria for an optimal delineation of integration areas in the context of the European Union. Although the EU and AFTA differ in many aspects, above all the state of development (and therefore the composition of trade) some more theoretical arguments of his logic may apply to South East Asia as well:

The Heckscher-Ohlin theory suggests that wealth increase is a function of the differences in factor endowments: the more they diverge, the more can integration increase wealth. The theory of intra industry trade, however, affirms that wealth increases as a consequence of specialisation between more or less equally endowed countries. While the second theory explains why European integration has been beneficial to European countries, both theories somehow explain why ASEAN economic integration has not yet shown seizable results: The theory of intra-industry trade explains trade between developed economies where production and trade are highly specialised. This assumption, however, does not (yet) apply to most of ASEAN. As far as the Heckscher-Ohlin arguments are concerned, they explain why most of ASEAN trade is extraregional trade. Factor endowments within ASEAN are too similar to create intraregional trade. Of all this, we might infer, that a larger integration area, comprising a bunch of developed countries as well (such as APEC) would be more beneficial to ASEAN countries than liberalisation within AFTA.

Another criterion for the delimitation of an optimal integration area may be the existence of a net of interlacing trade flows even before integration, indicating comparative advantages which can be improved by integration. Integration between countries that did not trade before integration is likely to cause only trade diversion, crowding out more efficient third country suppliers.

Intra-regional trade has been on a low level in ASEAN so far, although countries already granted each other some preferences before the creation of AFTA (see section 2.1). This may have had two reasons: First, there may not have been adequate supply of goods which ASEAN really needed to import such as machinery and equipment. Next, the advantages offered by the Preferential Trading Agreement were only modest and did not have the force to divert trade very much.

\textsuperscript{35} cf. The World Bank, Liberalization, 1994, p. XIII.

\textsuperscript{36} Tichy, Gunther: Optimum Integration Area, 1992, p. 107-137.
Other criteria for the delineation of an optimum integration area are similar price structures, similarity of production and trade, the existence of scale economies, a similar stage of development and similar tariff and protection structures before integration, combined with a low level of external protection after integration. Following this logic, there may not really be a scope for a free trade area in South-East Asia at the present stage: Countries differ enormously in terms of development, especially after the entry of Vietnam (1995), Cambodia and Laos (both scheduled for 1997), and it is yet too early for them to reap economies of scale from intra-industry-trade.

1.3.4 Requirements of True Liberalisation

Lower tariffs and lower NTBs will considerably liberalise trade but other obstacles must be removed as well if liberalisation is to succeed. We need to take into consideration, that nowadays, nominal protection through tariffs is relatively low and tariffs are therefore often less efficient as trade obstacles than the wide range of administrative measures that can effectively hamper free trade. Quotas, import licenses, anti-dumping measures and “voluntary” export restraints (VERs) are only a few prominent examples of more than 600 types of obstacles to international trade that have been identified.

The European Union provides - in the caselaw of the European Court of Justice - impressive and often amusing examples of the sheer unlimited creativity of national bureaucracies and pressure groups when the loss of well protected market structures is at stake. Besides diverging technical standards, there is a huge variety of other measures,

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37 Freeing trade between countries with similar price structures will lead to specialisation and intra-industry trade within commodity groups while free trade between countries with diverging price structures will lead to Heckscher-Ohlin trade

38 In case the structure of production is very dissimilar (one country produces cars, the other produces agricultural goods), the FTA will lead only to the replacement of (more efficient) third country imports by less efficiently produced goods from the integration area.

39 This argument, however, is not unanimously accepted. As far as traditional internal (firm level) scale economies are concerned, studies carried out on the EU found out that intraregional trade did increase in the very goods that are not subject to scale economies. Besides, there is doubt on the potential of further internal scale economies in the EU since the market is still large enough to allow, in most cases, for several plants to exist. Similarly disputed is the presence of external scale economies. While internal scale economies favour large countries, external scale economies favour rich agglomerations.

40 The importance of a similar stage of development is heavily discussed in literature. While, according to one school, producers in technologically less developed countries should be exposed to tough international competition in order to enforce larger efforts in Research and Development, another school argues that domestic producers in technologically less advanced countries should be given time to close the gap because otherwise, polarisation effects may become likely, diverting investment in skill intensive branches towards the more developed countries.
ranging from labelling and packaging requirements to opening hours of border posts, delays in customs controls and special customs procedures,\textsuperscript{41} phytosanitary exams, certification requirements and even lax legislation on competition.\textsuperscript{42} Often, this type of discrimination is very subtle and difficult if not impossible to prove. Most national legal systems are sophisticated enough, that - even without increasing tariffs - national bureaucracies could prohibitively obstacle trade simply through tougher administration of already existing rules and procedures.

True liberalisation requires legally binding rules for trade between nations. For instance, reliable mechanisms must be created that guarantee the mutual recognition of technical norms, safety standards or certification procedures between countries. Exporters must be given the possibility to legally proceed against national bureaucracies which hamper free trade by unfair measures and these countries must be made reliable for the damage their protectionist measures cause. On the other hand, a minimum of harmonisation is necessary in order to protect certain levels of environmental or safety standards. A “right” mix between harmonisation, which often turns out to be too lengthy to keep pace with technological innovation, and mutual recognition must be found. Safeguard measures against free trade must be reduced to a minimum and subject to approval and continuing verification by international or supranational institutions.

A good example for such international co-operation is the European Union. Co-operation covers all of these areas (and many more) and the rules are incorporated in the \textit{primary law}\textsuperscript{43} and myriads of \textit{directives} and \textit{regulations}\textsuperscript{44} (\textit{secondary law}) which effectively protect free trade within the EU. The cornerstone of the system is the capacity of the European Union to pass acts that supersede national legislation in areas where national sovereignty has been delegated to the supranational level. Passing legal acts, however, is one thing - \textit{enforcing} them is yet another. Only thanks to an institution like the European Court of Justice which is able to pass legally binding sentences, the EU has achieved true progress in integrating its markets.\textsuperscript{45}

\textsuperscript{41} The probably most famous example was the French import regime for Japanese VCRs; cf World Bank: World Development Report, 1987, p. 141.

\textsuperscript{42} It is often neglected to mention that private economic agents can hinder free trade, too. After the strong devaluations of the Italian Lira in 1992, car producers throughout Europe had lowered their supply prices to their Italian retailers in order to keep their market share in Italy. Since, however, trade within the European Union is free, many customers from other EU countries went to Italy in order to buy new cars, which turned out to be up to 30\% cheaper than at home. Car producers then tried to forbid Italian retailers to sell cars to foreign customers. The EU Court of Justice has denounced such practices as unlawful (Case No. C-322/93P; Automobiles Peugeot S.A. and Peugeot S.A. versus EU-Commission).

\textsuperscript{43} Primary law consists of all the treaties establishing the EU such as the Maastricht Treaty or the Treaties of Rome.

\textsuperscript{44} Regulations are legal acts, passed by the EU, which are directly and immediately effective and do not need to be ratified by national Parliaments.

\textsuperscript{45} One of the most important rulings ever made is the Cassis de Dijon ruling, where the European Court of Justice ruled, that any product that complies with the rules of the producing member state must be
I would even dare to say that without such a strongly institutionalised co-operation in these many areas, the real dimensions and effects of trade liberalisation depend largely on the goodwill of national bureaucracies and to a marginal degree only on the presence or size of tariffs and official NTBs. But the problem about goodwill is that it is unreliable, especially in times when growth is slow and when economic difficulties increase protectionist pressures.

Last but not least, a lot of other factors can obstruct trade. Such factors are, to mention only a few examples, the higher costs of cross-border payments or cross-border telecommunications and a lack of co-ordinated regional planning, leading to inefficient infrastructures in border regions. They all may increase, deliberately or unconsciously, the costs of international trade.

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granted free access to all the other member markets, regardless of national legislation in the importing country. This principle has led to the phenomenon of reverse discrimination. For instance, the German Purity Law for Beer of 1516 (the world’s oldest food quality law) restricts the use of ingredients for beer to only four components: water, barley malt, hops and yeast (the last ingredient mentioned was added later only after being isolated by Pasteur) while all other ingredients continue to be prohibited under this law which is still in force. While German brewers need to continue to produce their beer according to the strict Purity Law, producers from other EU member states can sell their beers on the German market regardless of whether they fulfill the requirement of this German law or not. In the same context, the Court approved in early 1996 claims of a foreign beer producer against the German authorities regarding compensation of losses occurred during an import ban against this producer from 1981 to 1987.
2 Regional Trade Liberalisation in South-East Asia

2.1 ASEAN

ASEAN, the Association of South East Asian Nations was founded in 1967 (Bangkok Declaration) as a consequence of concerns about political stability within the South-East Asian region. In the context of Cold War, the objectives of ASEAN were predominantly political, although the Bangkok Declaration had stated the objective of increasing economic integration.\footnote{cf. De Rosa, Dean A.: The ASEAN Example, 1995, p.29.} ASEAN presently comprises seven countries: Brunei Darussalam, Indonesia, Malaysia, Philippines, Singapore, Thailand and, since July 1995, Vietnam. Laos and Cambodia will probably join in 1997 and, yet uncertain, Myanmar in 1998.

The basic aim of ASEAN economic cooperation were import substitution and enhanced complementarity between member economies through freer trade while an appropriate division of gains should be guaranteed through regionwide industrial planning. In 1972, a UN report on regional economic cooperation, commissioned by ASEAN foreign ministers in 1969, was discussed on the 5th ASEAN Ministerial Meeting in Singapore. The UN proposals aimed at a strategy of import substitution on a regional scale through freer trade and suggested region-wide industrial planning to compensate for the unequal distribution of gains that was expected from intraregional trade liberalization.\footnote{cf. Ravenhill, John: Changing Incentives, 1995, p. 851.}

In 1976 finally, the ASEAN heads of state adopted on their Bali meeting two (and subsequently three) coordinated investment programmes and a preferential system of trading agreements:\footnote{cf. De Rosa, Dean A.: The ASEAN Example, 1995, p. 30.}

The AIP (ASEAN Industrial Projects Programme) was established in 1978. Its objective was the promotion of complementary economic structures in a region that was largely characterized by countries with mostly similar factor endowments and therefore competitiveness in economic structures, except for Singapore (and Brunei which entered later). Under the AIP, jointly owned industrial projects should ensure an equitable allocation of industries (which then were supposed to have a regional monopoly) in ASEAN member countries. But due to the heavily bureaucratic approach that stood in contrast to the market-oriented philosophies of member countries, only two of these projects were realized (projects that had already been planned on the national level) while other proposals foundered due to disputes between member countries, within member countries or simply due to the lack of interest from the private sector.
Therefore, AIP cannot be considered as a very successful example of ASEAN cooperation.\(^{49}\)

The AIC (ASEAN Industrial Complementation Scheme), established in 1978 and implemented in 1981, aimed to facilitate the exchange of components within the region, thus creating economies of scale for producers. But again, success was very limited: only 2 projects out of 30 proposals, both in the automotive sector, were approved.\(^{50}\)

A similar programme, the BBC (Brand-to-Brand Complementation) was launched in 1988 aiming at the facilitation of the exchange of car components. Under the BBC which in 1991 was opened to other sectors than automotive components, parts were traded with a margin of preference of 50\% over other suppliers. In 1995, eight companies of three countries (Malaysia, the Philippines and Thailand) have had proposals approved.\(^{51}\)

Another project to promote regional production was the ASEAN Industrial Joint Venture Agreement (AIJV) of 1983. Goods produced by investors of at least two ASEAN countries with an ASEAN equity share of at least 51\% could enjoy ASEAN-wide preferences if the goods satisfied certain origin requirements.\(^{52}\) Due to long delays caused by the state bureaucracies and a lack of publicity, no project was approved in the first five years, while 23 projects had been approved by the end of 1994. The programme suffered from heavy bureaucratic proceedings and from member countries’ reluctance to grant the tariff preference (which amounted to a 90\% margin on tariffs) to some projects. Sometimes, participating countries even require that the projects import goods from them. Most of the projects are located in Thailand or Malaysia and have third country equity participation. The impact of the programme on the generation of extra-investment is not clear.\(^{53}\)

In 1996, ASEAN member countries have decided to replace the BBC and the AIJV by a new scheme, the ASEAN Industrial Cooperation Scheme (AICO).\(^{54}\) This scheme, which seems to be more promising than its predecessors, is explained later in the context of AFTA.

**In summary, the results of ASEAN industrial cooperation to date are rather disappointing.** Similar schemes in Latin America (Andean Pact) didn’t show

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\(^{53}\) For more information, see Panagariya, Arvind: Should East Asia Go Regional?, 1993, p. 22f.

\(^{54}\) cf. ASEAN: Industrial Cooperation Scheme, 1996.
encouraging results either, while industrial planning within the Central American Common Market (CACM) seemed very promising in the beginning. But even in this case, differences over the equitable distribution of gains (e.g. about the location of new plants) led to CACM’s end.55

The Agreement on ASEAN Preferential Trading Arrangements (PTA) came into being in 1977 and tried to substantially reduce tariffs on intrabloc-traded goods. The preferences negotiated bilaterally or multilaterally were to be granted on an “ASEAN MFN basis” to all member countries.56 In a first stage, margins of preference amounted to 10% only and were applied essentially to products that were not traded or only marginally traded between the countries. Other bureaucratic impediments ensured that the overall transaction costs of trade would remain significant.

While these preferences were first exchanged on a product-by-product basis, the second stage consisted of across-the-board reductions that were adopted on certain import values that gradually increased. But even in this stage, safeguard measures and, once more, the fact that the goods concerned were essentially imported from outside the region, kept intra-bloc trade flows on their former level. Given the modest result of the first two stages, new proposals were made in the mid-Eighties, calling for the creation of a free trade area between Singapore and the other members who would form a customs union.57 But as this plan posed a serious threat to other forms of NTBs like administered licensing or quantitative restrictions, the plan was abandoned.

The final stage of PTA liberalisation began in 1987 when it was agreed to widen the PTA margins of preference from 25% to 50% and to liberalise rules of origins and preferences granted to products from ASEAN joint ventures or cooperative projects. Since these projects - as mentioned above - had rather limited significance and given the weaknesses of the outlined PTA system, even the results of this stage didn’t bring any considerable progress by the beginning of the 1990s. Additionally, the issue of the growing importance of NTBs as impediments to international trade had not yet been tackled.

All in all, the efforts of ASEAN member countries to liberalise and to promote intra-regional trade - through tariff reductions and industrial cooperation - have shown only modest results. Due to vested interests within member states, jealousies of national bureaucracies and the competitiveness of the economies rather than their complementarity, progress in regional economic integration was slow and the intrabloc-share of ASEAN exports even declined from 21% to 18% between 1970 and 1988. The results seem even more disappointing when excluding trade with the free port of

56 cf. Agreement on ASEAN Preferential Trading Arrangements (1977), Article 8, Paragraph 2.
57 This was the “Rieger-Plan” which suggested that Singapore should not become part of the customs union as its membership, given its free trade regime, would have undermined the import tariffs of the other member countries.
Singapore (which is essentially entrepôt trade): the share of intrabloc trade then even declines from 6% in 1970 to 4% in 1988. From the above, we may also draw the conclusion that economic incentives for intrabloc trade in the region - excluding trade with Singapore - are rather small.

ASEAN’s political achievements are remarkable and useful for the creation of AFTA. Despite the fact that success of economic cooperation was quite limited, ASEAN should not be dubbed as a failure: ASEAN has allowed member countries to build up political relations and mutual confidence, allowing the articulation of shared perspectives on major issues facing the grouping.\(^{58}\) It has helped the region to maintain its political stability. As far as economic issues are concerned, it has provided members with expertise and experience in the field of regional trade liberalisation. It has further set the base for the ASEAN Free Trade Agreement (AFTA).

### 2.2 AFTA

The slow progress in trade liberalisation by ASEAN was one of the reasons for ASEAN member countries to establish a free trade area among ASEAN countries, the ASEAN Free Trade Area (AFTA) in 1992. Moreover, the then uncertain outcome of the UR (Uruguay-Round) negotiations on the one hand and the completion of the European Single Market and preparations for the North American Free Trade Agreement (NAFTA)\(^ {59}\) on the other pushed ASEAN countries to move closer together as the fear grew of being left out in the cold of a world moving towards the construction of regional blocks. Last but not least, ASEAN needed a new raison d’être after the end of the cold war.\(^ {60}\)

**AFTA is a free trade area. It is a discriminatory agreement under Art. XXIV of the GATT.** According to its name, AFTA is a free trade area, which means that countries maintain individual tariff regimes towards non-member countries - contrary to the idea of a customs union where members apply a common external tariff. Thus, AFTA has to keep a regime of rules of origin (as outlined in Section 1.3.2), too.

**The key vehicle of AFTA is the Common Effective Preferential Tariff (CEPT).** The CEPT scheme is applied to goods originating in ASEAN and requires member states to lower their tariff rates on most goods to between 0 and 5% by the year 2003. This CEPT is more encompassing than its predecessor, the PTA. While initial plans had excluded most agricultural products listed in chapters 1 to 24 of the Harmonised System

\(^{58}\) cf. De Rosa, Dean A.: The ASEAN Example, 1995, p. 35.

\(^{59}\) Potential losses of East-Asian countries through the implementation of NAFTA would however be small as an empirical estimate suggests and would represent just 1% of potential gains through the successful implementation of the GATT UR; cf. Lewis, Jeffrey D./Robinson, Sherman/Wang, Zhi: Uruguay-Round, p. 2.

(HS) and other similar unprocessed products, the 26th ASEAN Economic Ministers Meeting (AEM) in September 1994 decided to widen the scope for the inclusion of agricultural products. Now, nearly all manufactures and nearly all unprocessed or processed agricultural products are to be covered by the CEPT scheme. The CEPT, as it stands today, will cover nearly 98% of all tariff lines in its final stage and it will reduce the average tariff rates on CEPT products from 7.76% today to 2.95% in 2003.\textsuperscript{61}

One difference between CEPT for AFTA and the PTA of ASEAN is, that CEPT concessions are granted reciprocally only\textsuperscript{62}, while PTA concessions were granted on an “ASEAN-MFN-basis” to all ASEAN member states. Therefore, countries are likely to include all those goods in their CEPT Products Lists (where goods that are to be liberalised are included), which they would like to export at a preferential rate themselves.

\textit{Exceptions from liberalisation are listed in the Exclusion Lists.} The CEPT concept provides for three lists of exclusion: The General Exceptions List, the Temporary Exclusion List and the Sensitive List with unprocessed agricultural products.

The \textit{General Exceptions List} (Art. 9)\textsuperscript{63} allows for measures that a country “considers necessary for the protection of human, animal or plant life and health and protection of articles of artistic, historic and archaeological value” and includes about 2% of member states tariff lines.

The \textit{Temporary Exclusion List} includes products at the HS 8/9 digit level that are sensitive to member states (Art. 2 (3)). Countries excluding certain products temporarily from the CEPT scheme are not granted preferential treatment for their exports of the same products by their ASEAN partners. The Temporary Exclusion List, which included 7% of member states’ tariff lines in 1995, is independent from the General Exceptions List. About 45% of the temporary exclusions list is constituted by the three sectors chemicals, plastics and vehicles.\textsuperscript{64} Countries must remove products on this list in five equal instalments, and include them into the CEPT by 1 January 2000.\textsuperscript{65}

The \textit{Sensitive List} comprises unprocessed agricultural products, for which special arrangements will be created. However, there is neither a compulsory schedule for tariff reductions nor a targetted final tariff, as is the case with all other goods. The tariff reduction commitment under the special arrangement will only have to go beyond the commitments that member countries made in the Uruguay Round/ \hfill

\begin{flushleft}
\textsuperscript{61} cf. ASEAN Secretariat: AFTA Reader, Volume III, 1995, p. 4.
\textsuperscript{63} All the articles quoted refer to the “Agreement on the Common Effective Preferential Tariff (CEPT) Scheme for the ASEAN Free Trade Area (AFTA).
\textsuperscript{64} cf. ASEAN Secretariat: AFTA Reader, Volume II, 1995, p. 14-23.
\textsuperscript{65} This is the new date after the schedule had been revised (cf. ASEAN: Protocol, 1995, Art. 1).
\end{flushleft}
Free trade in the area (that means tariff rates between 0% and 5%) shall be achieved by 2003 after the schedules have been accelerated. A “Normal Track Programme” and a “Fast Track Programme” determine the liberalisation schedule. While the ASEAN PTA was an open-ended commitment to trade liberalisation, CEPT sets clear schedules for the reduction of tariffs to rates between 0 and 5% for all goods apart from those on the exclusion lists. The schedules, initially aiming at free trade within the region by 2008 have been revised in order to achieve this goal already by 2003.66.

In the Normal Track Programme, goods with rates above 20% will have their rates reduced to 20% by the 1 January 1998 and subsequently to 0-5% by 1 January 2003. Products with rates already at or below 20% will have their rates reduced to 0-5% by 1 January 2000.

In the Fast Track Programme, goods with rates above 20% will have their rates reduced to 0-5% by 1 January 2000 and products with rates at or below 20% will have their rates reduced to 0-5% by 1 January 1998.

The recently entered Vietnam must reach free trade by 1 January 2006.67 Vietnam, which became the seventh member of ASEAN on 28 July 1995 has to liberalise its trade after the following schedule: Vietnam has to reduce its tariffs, starting on 1 January 1996, to the target level of 0% to 5% by 1 January 2006. The temporarily excluded products shall be brought into CEPT in five equal instalments, beginning 1 January 1999 and ending 1 January 2003. Vietnam has to phase in agricultural products which are temporarily excluded beginning 1 January 2000 and ending 1 January 2006. The arrangements of the former ASEAN PTA do not apply to Vietnam.

The tariffs applied under the ASEAN Industrial Joint Venture Scheme (AIJV) will be allowed to slide accordingly which means that the 90% preferential margin will be applied to the new lower tariff as well. The AJIV privileges will cease at the end of 2002.

A new scheme for industrial cooperation, AICO, is a more wholehearted approach to industrial cooperation and its provisions show that ASEAN countries have learnt from past experience with industrialisation schemes. As mentioned before, ASEAN member countries have decided to replace the BBC and the AIJV by a new scheme, the ASEAN Industrial Cooperation Scheme (AICO).68 This scheme is supposed to be less bureaucratic than its predecessors and aims at fostering cooperation in the private sector. Companies of at least two ASEAN countries, that are incorporated and operating in 21

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68 cf. ASEAN: Industrial Cooperation Scheme, 1996.
member countries and have a minimum of 30% national equity\textsuperscript{69} are eligible for exports under the CEPT rate if they are able to prove that they share resources, that they add to industrial complementation or that they practice industrial cooperation by joint ventures, joint manufacturing, technology transfer etc.\textsuperscript{70} A special incentive to cooperation is that the lower CEPT tariffs of 0-5\% apply on AICO products already now - regardless of the participating countries’ liberalisation schedules for these products - and these lower CEPT rates even apply on items on the temporary exclusion list. The Agreement on AICO requires national authorities to decide on applications within 60 days after receipt, and preferential tariff rates are to be granted within another 60 days from issuance of a Certificate of Eligibility (COE). Product approval is at the HS 8-digit level and above.

\textit{The AICO scheme shows that ASEAN countries recognise that their past efforts in industrial cooperation have suffered a bureaucratic death.} The new scheme is relatively market driven, it aims at the private sector and it wants to ease cooperation for companies located in different member countries. However, the question might be raised why the AICO concessions (application of final CEPT tariffs already today, application of CEPT on products that are on the temporary exclusion list) should be limited to companies that engage in that particular kind of cooperation required by the AICO agreement. Cooperation should not arise from potentially distorting preferential treatment but from economic considerations.

\textit{The removal of NTBs and cooperation in trade related areas are part of AFTA.} CEPT provides for the elimination of Non Tariff Barriers (NTBs) such as quotas or foreign exchange restrictions in the case of trade in products covered by the CEPT scheme (Art. 5).\textsuperscript{71}

In the case of other NTBs, an Interim Technical Working Group has been set up to identify the different types of NTB. The most current NTB in ASEAN countries are customs surcharges (applied on 2,683 tariff lines), technical measures (568 tariff lines), product characteristic requirements (407 tariff lines) and additional Charges (236 tariff lines). Other measures like monopolistic measures or state monopolies occur less frequently.\textsuperscript{72}

\textit{An ASEAN Consultative Committee Standards and Quality (ACCSQ) has been set up to tackle the problems of Technical Barriers to Trade (TBT).}\textsuperscript{73} The ACCSQ shall work towards the harmonisation of standards and conformance of procedures. Three working groups have been put up to; one is charged with standards and their

\textsuperscript{69} This is, however, negotiable in case the companies fulfil the other requirements.

\textsuperscript{70} Art. 3 of the Basic Agreement on the ASEAN Industrial Cooperation Scheme.

\textsuperscript{71} cf. \textit{ASEAN Secretariat}: AFTA Reader, Volume I, 1993, p. 34.

\textsuperscript{72} cf. \textit{ASEAN Secretariat}: AFTA Reader, Volume III, 1995, p. 9ff.

\textsuperscript{73} cf. \textit{ASEAN Secretariat}: Consultation on Standards in ASEAN, without date, Internet: http://www.asean.or.id.
harmonisation, another seeks to establish a framework for the mutual recognition of conformity assessment practices and the third works toward mutual recognition of calibration and test reports. Members of the ACCSQ are the national standard bodies of ASEAN member countries.

**Cooperation also includes the broad field of customs regulations.** The revised version of the ASEAN Customs Code of Conduct (1983) of 1995 sets out rules for trade procedures such as customs valuation. Customs valuation is not yet unified in AFTA and member countries currently apply different systems.\(^7^4\) The harmonised new system shall be based on the “Agreement on Implementation of Article VII of the GATT 1994” and be implemented by member countries by the year 2000. While the scope of this Agreement is limited to intraregional trade, it states clearly that “the Code shall serve as a guide *without the force and effect of a legal instrument.*” Member countries, however, are presently preparing for turning this Code into a legally binding agreement.

Further areas of cooperation set out in the ASEAN Customs Code of Conduct include the harmonisation of the product nomenclature, where presently several versions of the Harmonised System (HS) are being used by member countries. The Code aims at harmonisation up to the 8-digit level.\(^7^5\) Harmonisation of product nomenclature is crucial because CEPT concessions are based on *reciprocity*. Therefore, positions in the tariff codes should be the same in each member country.

**Other areas of cooperation have already been identified, but no seizeable progress has been achieved so far.** Cooperation in the fields of intellectual property protection are under ways and countries plan to set up an ASEAN Patent and Trademark System. Intellectual property protection is perceived as a necessity if technology is to flow into ASEAN countries.\(^7^6\)

Cooperation in services is to be deepened in the future, but no remarkable progress has been achieved so far.\(^7^7\) Other areas of cooperation include Finance and Banking or Transport and Communication.

**The actual success of AFTA is yet difficult to predict, due to several uncertainties. The institutional weakness and the lack of specific clauses underlie AFTA’s high dependence on political goodwill.** A lack of details in the Singapore Declaration compared to the NAFTA or EEA agreements reveals AFTA, at least to a certain degree, as a politically motivated gesture. This lack of details could lead to uncertainties and also to overloaded ministerial agendas since the unwillingness of member countries

\(^{7^4}\) cf. ASEAN Secretariat: AFTA Reader, Volume III, 1995, p. 21; p. 25.

\(^{7^5}\) cf. ASEAN: ASEAN Customs Code of Conduct, Annex II.

\(^{7^6}\) cf. ASEAN Secretariat: AFTA Reader, Volume III, 1996, p. 33.

\(^{7^7}\) cf. ASEAN Secretariat: AFTA Reader, Volume III, 1996, p. 29.
regarding any transfers of sovereignty to an international or supranational body might lead to political debates about details. This is a probable outcome because ASEAN members prefer political dialogue to administrative or juristic arrangements. Another consequence of this unwillingness to transfer any sovereignty might be a rather toothless approach to liberalisation in areas where adjustments may hurt vested interests in member countries. In addition to this, the fact that exclusions in AFTA are to be considered at the HS 8- and 9-digit levels will facilitate targeted lobbying for protection since winners and losers of further liberalisation can easily be identified.

It is not yet sure to what extent other barriers to trade will be eliminated - partly because cooperation in other areas has only just started. However, it is also a question of the institutional structures of ASEAN to what extent member countries can be brought to eliminate the myriad of very subtle discriminations that exist in transboudary trade. The example of the European Union shows that the removal of other trade barriers (cf. Section 1.3.4) like, for instance, technical barriers to trade (TBTs) was of great relevance to liberalisation. It is not yet sure to what extent AFTA will be able to remove these trade barriers. To come back to the example of TBTs, it is crucial whether countries embrace more an approach towards harmonisation of standards or towards mutual recognition.

In the EU, harmonisation procedures were lengthy, since each country tried to make the European standards become as close as possible to its own national standards. Thus, these procedures could not keep pace with technological change. Only in the late 1970s, after the European Court of Justice had passed its Cassis de Dijon ruling (imposing that any product that has been produced according to the rules of the producing member state must be granted access to the markets of other member states without regard to their rules), TBTs started to lose their trade obstructing character. Therefore, the mutual recognition of standards and the institutionalisation of ways to enforce it, which is not yet part of AFTA would yield larger benefits. The pressure arising from it might even accelerate harmonisation procedures.

Problems could arise from the present rules of origin. Since Singapore and Brunei are virtually free trade countries, chances are that exporters will try to enter ASEAN through these two “loopholes”. The ASEAN Chambers of Commerce and Industry have therefore suggested that a minimum transformation requirement would be necessary

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79 Although mutual recognition is more efficient than harmonisation, there is a need for a certain level of harmonisation, because otherwise, one incurs the danger, that the countries with the lowest level of consumer protection or safety/environmental standards have an advantage and that higher standards subsequently need to approximate the lowest level. However, this argument should not be overrated: Higher standards in one country can also raise the reputation of that country’s national industry. National producers can reap an advantage through reputation gains, enabling them to differentiate themselves and their products on grounds of quality from foreign competitors.

80 For instance, such a requirement could impose that a product that has not yet achieved ASEAN origin would have to undergo a transformation within an ASEAN country that would shift the good into a
in order to prevent the relatively liberal rules of origin\(^\text{81}\) from being abused. If such a requirement isn’t included, there is a risk that multinational suppliers enter AFTA by exporting their goods to a subsidiary in Singapore at a low *transfer price*, carry out some minor transformations and then reexport the goods to other ASEAN countries as products of ASEAN origin.\(^\text{82}\) To prevent this, the rules of origin would therefore need to be rewritten. The Singapore question must not be underestimated since a considerable part of intra-regional trade occurs between Singapore and the other countries (see section 4.2). Indeed, Singapore is in a particular situation as we will see later when discussing the results of the CGE models on AFTA.

**Another weakness might be the lack of a common external tariff.** It is therefore doubtful, whether the creation of AFTA will give ASEAN countries a greater say in the world trade system, as some have suggested. Member countries of a FTA - unlike those of a Customs Union (CU) like the EU - continue to pursue individual trade policies and are less likely to speak in one voice. This is not surprising, given the variety of foreign trade regimes, ranging from free trade countries like Singapore and, to a lesser extent, Brunei and Malaysia on the one hand and some large, more protectionist AFTA member countries on the other.

**Figure 2.1: GNP per capita in ASEAN member countries**

![Graph of GNP per capita in ASEAN member countries](image)


different tariff line. The bureaucratic efforts, associated with such requirements, and their trade obstructive character are, however, remarkable.

\(^\text{81}\) These rules specify that goods “shall be deemed originating from ASEAN Member States if at least 40% of its content originates from any Member States”; *ASEAN Secretariat: AFTA Reader, Volume I*, 1993, p. 53.

\(^\text{82}\) For the nature of rules of origin, see chapter 1.
**AFTA has no plans for an equitable distribution of gains from free trade.** Another surprise is (at least for the European author of this report) that AFTA has no plans so far for an equitable distribution of gains, for instance through the establishment of a regional fund like the one existing in the EU, respectively in the EEA. However, differences in the state of development and in terms of GDP within AFTA are still large and will even increase once Vietnam, Laos and Cambodia join the agreements.

**Macroeconomic policy coordination is a prerequisite if a regional integration agreement (RIA) shall succeed.** Uncoordinated macro-policies in countries which are linked by free trade arrangements may cause problems (for instance regarding the balance of payments) which are likely to create pressures to reverse the liberalisation process. AFTA would not be the first regional arrangement to experience such difficulties. Countries also need to make sure that the loss of tariff revenue through liberalisation is compensated by other revenue.\(^83\)

Of course, the coordination of macro-policies would restrict fiscal and monetary autonomy and therefore limit the member states’ independence. However, it would be naive to believe that simple non-coordination of macro-policies would help in any way safeguarding fiscal and monetary independence in a regional integration area.

**AFTA’s success does also depend on its institutional strength and the control of whether member countries fulfill their obligations.** The creation of common institutions might be necessary to survey that AFTA provisions are being observed by member countries. The creation of common institutions could also be necessary to coordinate areas of cooperation, which are likely to expand if CEPT for AFTA proves to be effective. Success of AFTA will therefore depend on the member countries’ readiness to create, fund and respect such institutions.

The complete reluctance of ASEAN members to create a body similar to the European Court of Justice or the Dispute Settlement Mechanism of the WTO does not necessarily increase the credibility of the commitment towards liberalisation.

**The success of AFTA will also be a function of its openness towards other regional agreements and towards the rest of the world.** It is yet unclear whether countries will grant concessions on an MFN basis to third countries, too (which might be economically desirable) thus eroding the preferential treatment granted to ASEAN partners.\(^84\) This question is however crucial for the treatment that ASEAN will experience in the world’s leading markets (EU, NAFTA, Japan) and this, again, will determine whether ASEAN has the capacity of attracting foreign direct investment (FDI). Export-oriented FDI requires favourable treatment of ASEAN products on the world’s most important markets like the EU, Japan or North America, because the demand impulse for export-

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\(^83\) cf. Nadal de Simone, Francisco: Macroeconomic Perspective, 1995; I will more closely examine macroeconomic implication of AFTA in chapter 5.

\(^84\) There is some unconfirmed information, that the Philippines, which will host the next APEC meeting, plan to grant preferential treatment to APEC countries as well.
led growth is less likely to come from within the region than from outside. However, one might also argue that ASEAN’s growing markets might attract regional-market oriented FDI flows that could be more abundant if access from outside the market was more difficult. But, since open markets have been identified as crucial to the growth of ASEAN economies, members would probably gain considerably more in both kinds of FDI by pursuing an open-market philosophy. Moreover, the concept of the borderless factory stands at odds with closed regional blocs. The question of FDI in the context of trade liberalisation will be subject to more detailed analysis in chapter 5.

The question of AFTA’s openness plays a role in the bargaining context, too. While a fortress ASEAN might deter some foreign investors, it is also thinkable that closer integration between ASEAN countries might give ASEAN more political weight in trade negotiations and therefore prove more efficient as far as the ultimate goal of freer access to developed and world markets is concerned than MFN-style liberalisation gifts without requiring reciprocity, as some economists suggest. Given the high growth rates of ASEAN economies and their huge market potentials, such considerations have some appeal.

However, the bargaining power of ASEAN at the present stage is limited, because growth and wealth of ASEAN’s export-oriented economies still depend more on impulses from abroad than the outside world depends on ASEAN.

Other determinants of AFTA’s potential are the progress in APEC liberalization efforts and the future relations between AFTA and APEC and between AFTA and other regional arrangements. Will AFTA perceive itself as a medium of enhancing trade liberalization within APEC or will it perceive APEC as a competing trade agreement? Welfare effects therefore depend on how relations between the two concepts will develop. There are already signs of growing cooperation between AFTA and CER, a regional arrangement between Australia and New Zealand. The Second Informal Consultation between the ministers of the two arrangements, which took place on 13 September 1996 has identified fields of cooperation in the areas of customs and standards.

From all that was said until now, it becomes clear that more than this preliminary assessment of AFTA’s potentials and credibility can only be given when the FTA begins to have a real impact on member economies leading to the static (or dynamic) effects described, or, in other words, makes some actors win while others lose through the

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85 see also subsection 3.2.5.

86 For instance, ASEAN and CER have signed a Memorandum of Understanding concerning Cooperation on Standards and Conformance in September 1996. Although this memorandum is not legally binding, it may give impetus to further cooperation in this area.

87 A preliminary assessment of the potentials of closer cooperation between AFTA and CER can be found in Lloyd, P.J.: Should AFTA and CER link?, 1995, p. 5-15.
reallocation of resources. We will then see whether the agreement is robust enough to resist political pressures for protectionism or whether it will turn out as a farce similar to ASEAN economic cooperation.

2.3 APEC

APEC is a grouping of presently 18 countries: Australia, Brunei Darussalam, Canada, Chile, China, Hong Kong, Indonesia, Japan, South Korea, Malaysia, Mexico, New Zealand, Papua New Guinea, Philippines, Singapore, Taiwan, Thailand and the USA. Because all AFTA members are also members of APEC, it is worth considering APEC cooperation as well in the context of this paper.

**APEC is not a free trade area in the sense of Art. XXIV GATT.** It is a forum that has emerged from private initiatives in the region such as conferences among academics and consultations between businessmen in the 1960s. The elevation of these non-governmental links to the ministerial level, thus creating APEC, followed a proposal by the former Australian prime minister Bob Hawke in 1989 to create a regional forum where issues of economic cooperation should be discussed. APEC is an example of market-driven regional cooperation while older approaches to regional cooperation were based on less successful, bureaucracy-led regional industrialisation schemes within import-substitution programmes.

**Member countries have agreed to establish free trade in the area by 2010/2020.** In paragraph 6 of the Bogor Leaders’ Declaration of 1994, member countries agreed to establish free trade in the area by 2010 for the industrialised economies and 2020 for developing economies. This liberalisation process is to be complemented by trade and investment facilitation measures, including customs procedures, standards and investment principles. In addition to this, programs shall be established for human resource development, cooperation in science and technology as well as for the promotion of small and medium enterprises and measures to improve economic infrastructure.

**APEC, however, is no trade negotiating mechanism.** The way in which the trade liberalisation goes ahead is different from GATT-style trade negotiations. Although some members, especially the United States, would have preferred a more institutional, legalistic approach, the opinion prevails that liberalisation should go ahead in the “Asian way”, as an evolutionary, incremental approach, based on voluntary but concerted

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89 The special interest of Australia in such cooperation is pointed out in Jiro, Okamoto: Approach, 1995, p. 12ff.
unilateral liberalisation. The grouping is anxious not to appear as an inward-looking trade block but perceives itself as a voluntary, open economic association with the basic aim of reducing barriers to trade an investment, enhancing trade liberalisation in the region and strengthening the multilateral trading system.\(^9\) APEC perceives itself as a model of open regionalism\(^9\), a kind of \textit{WTO Plus}.\(^9\)

\textit{The region will reap considerable benefits from cooperation within APEC.} \(^9\) Not only do cooperation and mutual consultation help with the settlement of trade disputes but they are also likely to promote intraregional trade since trade increases with the familiarity that trade partners achieve. Further on, the setting up of regional information centres could make members benefit from \textit{economies of scale} due to the public good character of such institutions (as far as marginal costs in offering the product to other users are negligible). Furthermore, spillovers from APEC cooperation on the subregional level (e.g.: subregional cooperation and pooling of resources in areas such as the growth triangle Singapore-Johor-Riau) could promote the exploitation of complementarities between geographically near areas thus enabling subregions to gain a comparative advantage. In addition to this, APEC membership might help to attract FDI because it increases the credibility in member states’ commitment to being open to business. A credible APEC, given its size, would also have considerably more bargaining power in world trade matters than individual countries have and could promote global trade liberalisation.

\textit{Predictions on APEC’s success are difficult. As a market-driven approach, it has an economic raison d’être; its political weakness will however limit its possibilities.} The difficulties in assessing the impacts of APEC are due to several unique characteristics of the grouping: APEC is composed by 18 member countries that differ extremely in terms of size, socio-economic development and culture. While the considerable differences in factor endowments constitute a well appreciated potential for trade\(^9\), this diversity in general may entail diverging interests between member countries which makes a EU-style comprehensive and structured alliance non-viable. It is hard to imagine how countries like the US, China and Japan – well-known for their tense trade relations - could suddenly work well together in the long run within one single forum, since each party will struggle for a dominant position in APEC. In addition to this, there might


\(^9\) cf. \textit{Yoo, Jang-Hee}: Perspective, 1995, p. 7. In my opinion, such a commitment would include that member states lower their trade barriers on an MFN basis only. However, there is some information, that The Philippines, which will host the next APEC meeting in late 1996, consider granting the CEPT treatment of AFTA (see previous section) to imports from all other APEC members, too, without, however, extending this preferential treatment to the rest of the world.


\(^9\) cf. \textit{Yoo, Jang-Hee}: Perspective, 1995, p. 9; The fact that many member countries, in the past, practiced import substitution policies will further present other members the chance to exploit enormous “untapped commercial opportunities”, cf. \textit{Rajan, Ramkishen S.}: Lessons, 1995, p. 393.
even arise pressures aiming at the exclusion\textsuperscript{97} of one or more countries or countries might chose not to participate. It becomes therefore clear, that APEC will not become a strong institutional body in the foreseeable future, regardless of its intentions. The consequences of this on the liberalisation process are difficult to assess; so far, the region benefitted from export-led economic growth, a situation that made voluntary liberalisation not only easier but also a rationale for economic policy. However, we do not have any indication how the situation might change in an economically less pleasant environment with national vested interests calling for protection.

The agreement of member countries to continue to use the WTO settlement mechanisms as their primary channel for resolving disputes\textsuperscript{98} may please the WTO. But it might also be another sign of APEC’s institutional weakness and of the lack of trust in the reliability of regional cooperation in case of conflicting interests.

Next, views on APEC’s future are quite diverging: on the one hand, there are member countries (esp. the US) who would like to turn APEC into a more inward-looking, more discriminating trade negotiation mechanism; on the other hand, there are countries like Malaysia\textsuperscript{99} who have only lukewarm support for APEC’s activities. Agreement between member countries on APEC’s future will however determine the weight APEC has and the influence it can exercise as a group in the world of international trade. In this context, it will be interesting to see what relationship APEC will develop to the subregional groupings such as ASEAN/AFTA, ANZCERTA and NAFTA and how it is perceived by these arrangements. Will the relationship be complementary and beneficial or competitive in an anti-productive way?

The approach of voluntary, unilateral liberalisation bears a certain danger, that liberalisation will happen in the ASEAN way, where countries liberalised trade in goods that were not produced or not traded within the region and where economic impact (and therefore political resistance) remained low. In the case of APEC, however, this outcome should be less probable for the fact that member economies are less competitive than in ASEAN but more complementary.

Another question is whether MFN-style liberalisation should be granted to the rest of the world with requiring reciprocity or not. Young and Chye\textsuperscript{100} found out that extending MFN status to the rest of the world without requiring reciprocity would not be desirable for APEC member countries, while Martin, Petri and Yanagishima argue for MFN-based liberalisation in East-Asia without reciprocity requirements.

\textsuperscript{97} cf. Lewis, Jeffrey D./Robinson, Sherman/Wang, Zhi: Uruguay-Round, 1995, p. 44.
\textsuperscript{98} cf. APEC Bogor Declaration, 9th paragraph, 1994.
\textsuperscript{99} cf. Yumiko, Okamoto: APEC, Malaysia and Japan, 1995, p. 20f.
\textsuperscript{100} cf. Lewis, Jeffrey D./Robinson, Sherman/Wang, Zhi: Uruguay-Round, 1995, p.26; see also chapter 3.
3 The Impact of Trade Liberalisation on South East Asia: Empirical Findings

In this chapter, I will present the main findings of several empirical studies, based on CGE model simulations, that deal with the issue of trade liberalisation in South East Asia. These studies, however, will not be presented in a synoptical way, due to several reasons: First, each study tries to answer different questions and second, the data used by the authors has not always been the same. Third, the underlying assumptions and the models used differ from each other.

In spite of these differences, the conclusions are tendentially the same across most of the studies carried out.

The scope of this chapter, therefore, is to work out the factors that determine the gains trade liberalisation yields and how variations of these factors affect the outcome. Further on, the assumptions underlying the simulations and their significance for the outcome of the experiments will be subject to examination. As we will later see, the theoretical concepts of chapter 1 are largely reflected in the empirical results.

However, it must be stressed, that transitional problems (cf. Section 1.2), which occur during the liberalisation process and which play a crucial role for policymakers, are not considered in CGE model calculations.

These studies should not be considered as forecasts but as controlled experiments, keeping in mind that actual growth pattern will depend on more than just trade policy, for instance on macroeconomic policies.  

Section 3.1 will present the general findings of the studies that have been carried out. Readers, who are interested in particular aspects and quantifications will find more details in section 3.2, where some of the main features and results of each study are presented, or ultimately in the individual studies themselves.

3.1 Main Findings of the Empirical Studies

From the empirical studies, AFTA will not lead to considerable welfare gains. All the studies point into the same direction, suggesting that non-discriminatory, concerted trade liberalisation by as many countries as possible, covering the largest possible range of goods, would yield better results to participants than liberalisation within a relatively small, discriminatory trade bloc. The empirical findings largely reflect the concepts of trade theory as outlined in Chapter one. Below is a list of the basic

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findings of the empirical studies that have been carried out. Despite the differences between the individual studies, the results mostly share some main features.

* AFTA, as a discriminatory agreement between countries with largely competitive economic structures, will only have modest implications for welfare and the structure of output.

* Non-discriminatory trade liberalisation yields by far larger benefits than discriminatory trade liberalisation. Only for Singapore, discriminatory liberalisation might yield larger welfare gains if static gains are considered only. Considering dynamic gains, however, non-discriminatory liberalisation becomes preferable for Singapore as well.

* Gains from liberalisation accrue in the first place to the liberalising economy. However, one study on APEC (see section 3.2.5) found out that non-discriminatory liberalisation without requiring reciprocity from the rest of the world leaves member countries worse off than discriminatory liberalisation.

* The more countries liberalise, the better. Especially in the case of the less desirable discriminatory liberalisation, the outcome depends heavily on the size of the agreement.

* Concerted, simultaneous liberalisation shows superior results to unconcerted liberalisation, due to less adverse terms of trade effects on the liberalising economy.

* The comprehensiveness of a liberalisation scheme has a crucial role in determining the success of liberalisation: The more products are included in the liberalisation scheme, the larger are the benefits for the participating economies.

* The determination of the exact magnitude of gains from liberalisation is sensitive to variations of the assumptions about elasticities and the trade restrictiveness of NTBs.

* Excluding countries from liberalisation makes all countries worse off, but hits the excluded economies most.

* Static gains from resource allocation are quite small compared to the potential dynamic gains. Capitalising even small increases in growth rates shows how large the impact of such dynamic gains can be.

* The expansion of output and trade is several times larger in the case of non-discriminatory liberalisation than in the case of discriminatory liberalisation and reflects comparative advantage better.

* In the case of liberalisation across the Pacific Rim regions, the larger ASEAN countries gains most compared to all other countries in the region.
* Exchange rates depreciate in the liberalising economies.
* As a result of freer trade, factors move from sectors without comparative advantage into the export-oriented sectors.

3.2 The Empirical Studies

3.2.1 A study by Lewis, Robinson and Wang (World Bank), 1995

Lewis, Robinson and Wang carried out CGE simulations on trade liberalisation along APEC lines. If static gains are considered only, APEC has rather modest impact on member economies. If dynamic gains are also taken into consideration, the simulation results are more encouraging. It comes out, that excluding countries from the FTA makes the excluded countries significantly worse off but also lowers the gains that other countries reap from the FTA. The larger the FTA is, the larger are the gains. The highest benefits, however, stem from worldwide non-discriminatory liberalisation.

Lewis, Robinson and Wang constructed a ten sector, six-region CGE-model to assess the consequences of trade liberalisation in the East-Asian region along APEC lines. The six economies of the model are China (including Hong Kong), Japan, the USA, ASEAN4 (i.e. Indonesia, Malaysia, Philippines and Thailand), the Asian NIE (Singapore, Korea and Taiwan) and the EU. The fact that Singapore, for the purpose of this study, is not part of ASEAN but is part of the NIE is worth noting; as we will see later in the study conducted by DeRosa, Singapore’s particular situation deserves our attention.

Several liberalisation scenarios are considered. Scenario 1 takes only static gains into account while all other scenarios consider dynamic trade productivity linkages, too. In scenarios 1 and 2, trade liberalisation occurs along APEC lines. Experiment 3, 4 and 5 examine the effects of APEC liberalisation in case of the exclusion of either ASEAN4 (Scenario 3), China (Scenario 4) or the US (Scenario 5) from the process, while Scenario 6 examines worldwide trade liberalisation, including the EU and the rest of the world. The structure of the experiments is displayed again in table 3.1. The results of the experiments for ASEAN4 are shown in table 3.2. They represent the change after all the adjustments have occured without specification of any particular date.

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102 The Almost Ideal Demand System (AIDS) specification is used, giving wider possibilities for the modelling of elasticities and the model also includes equations generating positive externalities through both export expansion and the importation of new capital goods. The parameters for these calculations are based on guesswork. The time horizon of the model is “long enough” for full adjustments to occur, while factor markets clear and costs of adjustment such as transitional unemployment are not considered. For more details about the construction of the model, cf. Lewis, Jeffrey D./Robinson, Sherman/Wang, Zhi: Uruguay Round, 1995, p. 27ff and p. 55ff.
Table 3.1: The structure of the experiments

<table>
<thead>
<tr>
<th>Experiment No.</th>
<th>Types of gains considered</th>
<th>Regional coverage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Experiment 1</td>
<td>static</td>
<td>APEC</td>
</tr>
<tr>
<td>Experiment 2</td>
<td>static and dynamic</td>
<td>APEC</td>
</tr>
<tr>
<td>Experiment 3</td>
<td>static and dynamic</td>
<td>APEC without China</td>
</tr>
<tr>
<td>Experiment 4</td>
<td>static and dynamic</td>
<td>APEC without ASEAN4</td>
</tr>
<tr>
<td>Experiment 5</td>
<td>static and dynamic</td>
<td>APEC without US</td>
</tr>
<tr>
<td>Experiment 6</td>
<td>static and dynamic</td>
<td>Worldwide liberalisation</td>
</tr>
</tbody>
</table>


Table 3.2: Consequences of Free Trade in the Asia-Pacific region on ASEAN4
(All results in Percentage change from base)

<table>
<thead>
<tr>
<th>Exp. No.</th>
<th>Real GDP</th>
<th>Real Absorption</th>
<th>Real exchange rate</th>
<th>Terms of trade</th>
<th>Export/output share</th>
<th>Trade expansion</th>
<th>Trade creation</th>
<th>Trade diversion</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exp. 1</td>
<td>0.56</td>
<td>0.36</td>
<td>3.09</td>
<td>-0.40</td>
<td>1.36</td>
<td>6.12</td>
<td>6.35</td>
<td>5.65</td>
</tr>
<tr>
<td>Exp. 2</td>
<td>4.72</td>
<td>4.21</td>
<td>2.34</td>
<td>-1.13</td>
<td>1.62</td>
<td>11.09</td>
<td>6.99</td>
<td>19.63</td>
</tr>
<tr>
<td>Exp. 3</td>
<td>4.22</td>
<td>3.76</td>
<td>2.06</td>
<td>-1.07</td>
<td>1.44</td>
<td>9.92</td>
<td>7.35</td>
<td>13.95</td>
</tr>
<tr>
<td>Exp. 4</td>
<td>0.18</td>
<td>0.44</td>
<td>-0.06</td>
<td>0.72</td>
<td>-0.00</td>
<td>0.09</td>
<td>-2.95</td>
<td>6.42</td>
</tr>
<tr>
<td>Exp. 5</td>
<td>3.82</td>
<td>3.33</td>
<td>1.73</td>
<td>-1.14</td>
<td>1.33</td>
<td>9.04</td>
<td>11.18</td>
<td>7.07</td>
</tr>
<tr>
<td>Exp. 6</td>
<td>5.82</td>
<td>5.17</td>
<td>2.86</td>
<td>-1.27</td>
<td>1.96</td>
<td>13.51</td>
<td>7.02</td>
<td>46.93</td>
</tr>
</tbody>
</table>


The comparative static of Experiment 1 brought the following results: In the case of APEC-wide trade liberalisation, growth in real GDP, which measures the increased domestic production at base period prices, amounts to 0.56% in ASEAN4 (Asian NIE: 2.61%, Japan: 0.88%, China: 0.07%, US 0.03%). ASEAN4 experiences a relatively large trade expansion of 8.41bn USD or 6.12% (Japan: 6.46%, Asian NIE: 5.76%, China: 3.79%, US: 2.64%).

This scenario is supposed to lead to a depreciation of the real exchange rate of 3.09% in ASEAN4 (Asian NIE: 8.51%, Japan: 7.29%, China: 2.55%, US: 2.29%), leading to a slight deterioration in ASEAN4 terms of trade of 0.4% (deteriorations also occur in Japan with 1.33% and in the Asian NIE, while terms of trade ameliorate for the European Union by 0.4%, for China by 0.07% and for the US by 0.03%).

The Export/Output share would increase more in ASEAN4 than in any other region. The increase for ASEAN4 would be 1.36% (Asian NIE: 1.01, China: 0.54%, Japan 0.47% and the US 0.18%). With regard to trade creation and trade diversion, ASEAN4 sees its trade increase in a favourable way: Total trade creation - which means additional trade within APEC - leads to a 6.35% increase in trade or 5.9 bn USD. No trade diversion occurs but trade with non-APEC regions actually goes up by 2.5 bn USD, representing an increase of 5.7%, which is the best result for all APEC member regions.

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The larger welfare gains accrue to the regions with the highest initial tariffs. The increase in real absorption\textsuperscript{103} is about 0.36% for ASEAN4 (Asian NIE: 2.44%, Japan: 0.74%, China: 0.13% and US: 0.04%) The increases in real absorption reflect, of course, the increase in GDP growth, and are most significant in countries with a high initial level of protection, sustaining trade theorists who say that gains from liberalisation are primarily to the benefit of the liberalising economy.

ASEAN4’s net trade with with other Asian regions and the US declines but exports penetrate markets in Europe and in the rest of the world. The trade balances\textsuperscript{104} of ASEAN4 countries with other countries in the region slightly deteriorate (by USD 1.72bn in trade with Asian NIE, by USD 1.24bn with Japan, by USD 1.19bn with the US and by USD 0.42bn with China). On the other hand, the trade balance with the European Union increases by USD 1.22bn while the trade balance with the rest of the world even increases by USD 3.35bn.\textsuperscript{105}

ASEAN can reap profits from the complementarities between the countries of APEC. As far as the sectoral composition of trade is concerned, ASEAN can - like China - reap profit from the complementarities between the countries of the whole APEC region. In the trade with the US, exports of textile and apparel experience the largest expansion with USD 0.56bn. ASEAN4 exports to Japan will increase strongly in basic intermediates and in agricultural products other than grain. Given the similarities between Chinese and ASEAN4 output, it is not surprising that no relevant changes will occur in ASEAN4 exports to China, while ASEAN4 exports to the Asian NIE will be characterized by higher exports of agricultural products other than grain. While virtually no changes occur in sectoral trade with the EU, ASEAN4 exports to the rest of the world will experience particular growth in machinery and equipment (USD 4.47bn) and textile and apparel (USD 3.29bn), while exports of other agricultural products and basic intermediates to the rest of the world will decline.

Summarizing the shifts in ASEAN4 export trade with APEC and non-APEC regions, exports of machinery and equipment as well as textile and apparel will increase most (USD 4.55bn and USD 4.28bn respectively), while exports of energy and minerals will suffer the strongest decline of a still modest USD 0.59bn. The congruence between the aggregate trade shift and trade shift with the rest of the world underline the growing importance of extra-APEC trade for ASEAN4.

The change in the structural composition of output reflects the change in the composition of trade. These shifts will entail factor movements. Output of textile and apparel will increase by 12.2%, together with an increase of 21.1% in exports and 27.8% in imports. The latter is probably due to the removal of the high initial tariffs

\textsuperscript{103} Real absorption is defined as C+I+G while GDP is defined as C+I+G+NX=C+I+G+X-M.
\textsuperscript{104} The authors assume that the aggregate trade balance for each region remains unchanged.
\textsuperscript{105} For an interpretation of these results, cf. Lewis, Jeffrey D./Robinson, Sherman/Wang, Zhi: Uruguay-Round, 1995, p. 37.
going back to the times of import-substitution and protection under the *infant industry* argument. The machinery and equipment industry is likely to enjoy a similar increase in output (11.6%) with exports up 17.7% and imports up only 5.9%.

These shifts will induce factor movements between sectors. Thus, capital will move out of agricultural sectors and natural resources based sectors and pour heavily into textile and apparel (+12.6%) and into machinery and equipment (+12.0%). Labour will move most out of energy and minerals and out of basic intermediates and reallocate in textile and apparel (+11.2%) as well as in machinery and equipment (+10.7%).

The results obtained when taking into account dynamic trade-productivity linkages dwarf the effects of trade liberalisation when static gains are discussed only. Especially ASEAN4 can expect enormous gains from these linkages. Experiment 2 takes into account the positive feedbacks between trade and productivity which increase the benefits accruing to FTA participants further, changing the pattern of trade and structural change: ASEAN4 real GDP grows by 4.72% with real absorption up 4.21%, compared to only 0.56%, respectively 0.36% in Experiment 1. The export/output share would increase by 1.62% and this increase would be higher than in the static experiment (1.36%) while terms of trade would deteriorate more with -1.13%. In this dynamic experiment, ASEAN4 trade expansion would be USD 15.24bn with intra-regional trade up USD 6.48bn and a tremendous increase in extra-regional trade of USD 8.76bn. Similar accentuations can be identified when examining the changes in sectoral exports, where ASEAN4 exports would be up USD 15.2bn.

A further analysis shows, that the relative difference between the outcome when static gains are considered only and the outcome that takes into account dynamic gains, too, is much higher in the case of ASEAN4 (and, to a lesser extent, in the case of China) than in any other region. While both experiments show that an Asian FTA would have beneficial effects on participating economies including ASEAN4, the presence of trade-productivity dynamic linkages would make ASEAN4 the principal winner of such an APEC FTA.

The exclusion of structurally competitive China from free trade would affect ASEAN4 only slightly, while the exclusion of the US would have considerable negative effects. If ASEAN4 itself was excluded, practically no gains of liberalisation would occur to the ASEAN4 economies, underlining that gains from liberalisation occur primarily to the liberalising economy. The exclusion of China in Experiment 3 leaves ASEAN4 mostly unaffected with GDP growth still at 4.22%, underlining the competitiveness between both economies. ASEAN4 trade expansion is still around USD 13.63bn with trade with Asian partners up USD 6.17bn and trade with the rest of the world up USD 7.45bn.

In Experiment 4, ASEAN4 is excluded. This has obviously the worst effects, leading to only 0.18% of additional GDP. Virtually no trade expansion occurs and trade with Asian partners decreases by USD 2.74bn while trade with the rest of the world increases by only USD 2.86bn.
The exclusion of the United States, simulated in Experiment 5 has considerable effects, reducing GDP growth to 3.82% and trade expansion to USD 12.43bn. While trade with regional partners at USD 7.38bn is even slightly higher than in the all-region scenario, additional trade with the rest of the world is only USD 5.05bn. This comparatively large shift in the results can be attributed to the considerable potential of trade that the inclusion of the US as a large, developed economy with mostly complementary economic structures (compared to most other APEC members) offers.

**Worldwide, non-discriminatory liberalisation yields larger gains than any other type of liberalisation.** Experiment 6 finally simulates a FTA that comprises the European Union and the rest of the world as well - making liberalisation global. This simulation shows, that the first best solution remains global liberalisation with ASEAN4 GDP up 5.82%, the highest increase for all the countries taken into consideration in the model (Asian NIE: 3.31%; China: 2.92%, Japan: 1.74%, US: 0.24%, EU: 0.21%).

### 3.2.2 A study by Lewis and Robinson (1996)

Another study carried out by Lewis and Robinson shows that the implementation of the commitments of the Uruguay Round, has large welfare implications, especially if dynamic effects are taken into account. However, most gains from the UR stem from the reduction of subsidies and the phasing out of the Multifibre Agreement (MFA).

The impact of an ASEAN Free Trade Agreement on GDP and exports are relatively modest, and South East Asian countries are far better off pursuing worldwide liberalisation. Lewis and Robinson carried out a study using a CGE model of nine linked country models: Indonesia, Thailand, Philippines, Malaysia and Singapore (together), China including Hong Kong, the Asian NIEs (Korea/Taiwan), the US, Japan and the EU. Each country model has twelve sectors and two labour types and is linked to other countries through modeling of explicit trade flows. The construction of the model is similar to the model used in the study presented in Section 3.2.1.

Two sets of simulations were carried out. The first set estimates the gains arising from the completion of the Uruguay Round, while the second sets estimates the additional effects of further liberalisations.

In the first set, scenario 1 consists of the removal of **tariff barriers only** as agreed upon in the Uruguay Round (UR). Scenario 2 also considers other aspects of UR liberalisation, particularly the **reduction of subsidies** and the **phasing out of the Multifibre Agreement (MFA)**. Scenario 2A is based on the same liberalisation as scenario 2 but considers additionally **dynamic** trade productivity linkages. Table 3.3 displays the increases of GDP and exports for ASEAN countries.

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Table 3.3: The impact of the Uruguay Round on Welfare and Exports
(All results in percentage change from base)

<table>
<thead>
<tr>
<th></th>
<th>Uruguay Round Tariffs Only (Scenario 1) Static gains only</th>
<th>Uruguay Round Full Commitments (Scenario 2) Static gains only</th>
<th>Uruguay Round Full Commitments (Scenario 2A) Static &amp; dynamic gains</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>GDP</td>
<td>Exports</td>
<td>GDP</td>
</tr>
<tr>
<td>Indonesia</td>
<td>0.08</td>
<td>0.07</td>
<td>1.60</td>
</tr>
<tr>
<td>Thailand</td>
<td>0.54</td>
<td>3.10</td>
<td>0.81</td>
</tr>
<tr>
<td>Philippines</td>
<td>0.21</td>
<td>0.98</td>
<td>1.74</td>
</tr>
<tr>
<td>Singapore &amp; Malaysia</td>
<td>0.10</td>
<td>0.64</td>
<td>2.10</td>
</tr>
</tbody>
</table>


We can see that the reductions of subsidies and the removal of the MFA have much larger effects than the tariff reductions of the UR, confirming that today, tariffs are of lesser importance than other measures of trade policy. The consideration of trade productivity linkages makes gains from liberalisation grow remarkably; Thailand, for instance, gains only 0.81% in terms of GDP from liberalisation if static gains are considered only, while it reaps 3.40% of additional GDP if dynamic gains are taken into account as well.

In the second set of simulations, the authors measure the additional increases in GDP and exports (the latter are not reported here) in case of further liberalisations. The starting point is scenario 2 from above. Each experiment adds another step of liberalisation to those included in the previous one. Thus, the first three columns in table 3.4 show the additional impact on GDP of each additional step of liberalisation, while the last column shows the cumulative impact.

Table 3.4: Additional Effects of additional steps toward liberalisation on GDP
(Percentage change of GDP from base)

<table>
<thead>
<tr>
<th>Incremental Effect of</th>
<th>URA II</th>
<th>ASEAN FTA</th>
<th>APEC FTA</th>
<th>Free Trade</th>
<th>Total Effect</th>
</tr>
</thead>
<tbody>
<tr>
<td>Indonesia</td>
<td>0.40</td>
<td>0.03</td>
<td>0.66</td>
<td>0.25</td>
<td>1.34</td>
</tr>
<tr>
<td>Thailand</td>
<td>0.59</td>
<td>0.18</td>
<td>0.82</td>
<td>0.37</td>
<td>1.96</td>
</tr>
<tr>
<td>Philippines</td>
<td>0.67</td>
<td>0.14</td>
<td>1.17</td>
<td>0.32</td>
<td>2.30</td>
</tr>
<tr>
<td>Singapore &amp; Malaysia</td>
<td>0.23</td>
<td>0.04</td>
<td>0.29</td>
<td>0.09</td>
<td>0.65</td>
</tr>
</tbody>
</table>


In terms of GDP, the simulations show clearly that large benefits stem from the completion of another multilateral liberalisation along the lines of the Uruguay-Round. Free Trade along ASEAN lines yields only marginal benefits in terms of GDP, while

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107 cf. Chapter 1.
free trade along the much larger APEC lines leads to a remarkable additional increase in GDP.

Finally, total free trade, including the rest of the world leads to another increase of GDP between 0.09% in the case of the already open economies of Singapore and Malaysia on the one hand and 0.37% in the case of the initially less liberal Thailand. The small gains of ASEAN liberalisation and the larger gains of multilateral or at least APEC-wide liberalisation show that South-East Asia is better off focussing on world markets instead of regional markets.

### 3.2.3 A study by DeRosa (IFPRI), 1995

A study carried out by the IFPRI found out that the more countries participate and the broader the range of products covered is, the more positive are the effects on member economies. Apart from Singapore, all countries gain most from non-discriminatory liberalisation. Exact gains, however, depend largely on underlying assumptions concerning demand side elasticities and the restrictiveness of trade barriers. DeRosa carried out a CGE model analysis on the likely impacts of AFTA trade liberalisation on individual countries, using a static general equilibrium model with many features of the so-called Michigan model. Linear equations include the conditions for equilibrium in markets for 26 categories of traded goods, one non-tradable good and assumed homogenous labour services.\(^\text{109}\)

One of the shortcomings of the model is the exclusion of longer-term aspects of adjustment (longer-term aspects resulting from the pure theory of international trade such as convergence of factor rewards and goods prices as well as dynamic trade-productivity-linkages such as external effects (technological spillovers and innovation) or economies of scale. As we saw in the case of the studies conducted by Lewis, Robinson and Wang (Section 3.2.1 and 3.2.2), the inclusion or exclusion of such dynamic consequences can have an enormous impact on the outcome of simulation experiments.

Further on, the model reflects simultaneous adjustments in ASEAN while reflecting only partial adjustments in other countries. Another restriction is that the model assumes - for the lack of more specific data in the UNCTAD inventory of trade control measures in developing countries which has been used - that all imports are presently treated equally, whether they originate in other ASEAN countries, benefitting from preferential treatment under the PTA or any of the industrialisation schemes or not.

On the other hand, DeRosa differentiates his model results by considering different behavioral and technical parameters, too. His study therefore contains a sensitivity analysis of the of demand elasticity parameters and of assumptions regarding the

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\(^{109}\) Further details about the CGE model used by DeRosa can be found in DeRosa, Dean A.: The ASEAN Example, 1995, p. 38-44 and p. 77f.
restrictiveness of nontariff barriers in the determination of the impacts of liberalisation.\textsuperscript{110}

The study considers ASEAN less as an aggregate but focuses on the results for each individual ASEAN country, except Brunei Darussalam and Vietnam, which has entered ASEAN only in July 1995. The author differentiates four scenarios: The first three examine discriminatory trade liberalisation between AFTA countries and vary on the range of goods included (scenario 1: selected manufactures only; scenario 2: all manufactures; scenario 3: all goods) while scenario 4 examines the probable outcome for non-discriminatory liberalisation, covering all goods. The main results of the study are displayed in tables 3.5 to 3.8 and are obtained using middle elasticity parameters\textsuperscript{111} and the middle value for the import restrictiveness of NTBs\textsuperscript{112}.

\textit{The broader the range of products subject to trade liberalisation is, the stronger is the impact on member economies. Singapore is the only country to gain considerably from discriminatory liberalisation.} Table 3.5 reports the basic results for an experiment where trade is liberalised between AFTA member states for selected manufactures on a discriminatory basis.

**Table 3.5: Changes as results of AFTA (selected manufactures) - Scenario 1**

<table>
<thead>
<tr>
<th>SCENARIO 1</th>
<th>Expenditure (in %)</th>
<th>Wage Rate (in %)</th>
<th>Exchange Rate (in %)</th>
<th>World Trade (in mn USD)</th>
<th>Welfare (in %)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Indonesia</td>
<td>0.09</td>
<td>0.43</td>
<td>-0.28</td>
<td>130.29</td>
<td>0.13</td>
</tr>
<tr>
<td>Malaysia</td>
<td>0.66</td>
<td>1.78</td>
<td>-0.39</td>
<td>213.06</td>
<td>0.78</td>
</tr>
<tr>
<td>Philippines</td>
<td>0.14</td>
<td>0.32</td>
<td>-0.47</td>
<td>69.91</td>
<td>0.18</td>
</tr>
<tr>
<td>Singapore</td>
<td>0.96</td>
<td>2.09</td>
<td>1.34</td>
<td>426.64</td>
<td>1.69</td>
</tr>
<tr>
<td>Thailand</td>
<td>0.14</td>
<td>1.11</td>
<td>-0.30</td>
<td>112.04</td>
<td>0.20</td>
</tr>
<tr>
<td>ASEAN</td>
<td></td>
<td></td>
<td></td>
<td>951.94</td>
<td>(0.89%)</td>
</tr>
</tbody>
</table>

Source: De Rosa, Dean A.: The ASEAN Example, 1995, p. 46.

We can see that, in terms of welfare, the impact on member countries is rather modest, with the relatively open economies of Singapore and, to a lesser extent, Malaysia reaping considerably higher benefits, than the other countries. This is not very surprising, since Singapore has economic structures which are complementary to those of the natural-resource abundant countries. It will therefore serve as a primary source for the higher demand of imported goods once trade barriers get lower within the region.

\textit{The currency of Singapore will be the only one to appreciate while the other currencies tend to depreciate.} This is natural, given the need for an equilibrated balance of payments: Singapore, as an already open economy, will not develop much additional demand for

\textsuperscript{110} Further details on the parameters used can be found in DeRosa, Dean A.: The ASEAN Example, 1995, p. 41ff and p. 54.

\textsuperscript{111} The values for the demand elasticity parameters range between 2.0 and 3.0 for manufactures and 4.0 for primary commodities (cf. DeRosa, Dean A.: The ASEAN Example, 1995, p. 42).

\textsuperscript{112} This means that the removal of NTBs is supposed to lead to a 25% increase of administered imports.
imports from other ASEAN countries, while the latter will increase their demand for imports from Singapore. It becomes clear that the natural resource-abundant countries will have to adjust their exchange rates downward in order to expand exports which in turn will finance the increased demand for imports. For Singapore, the need for maintaining the balance of international payments leads to an appreciation because demand for the country’s exports is much higher than its demand for imports. The expansion of world trade is relatively moderate for most countries while Singapore will be able to increase its trade volume considerably.

**Effects tend to become larger with an increasing number of products that are included in the liberalisation scheme.** Table 3.6 shows the case of discriminatory liberalisation of trade in *all manufactures* between AFTA member states. It becomes clear, that the effects of a broader liberalisation as far as the range of traded goods is concerned are stronger but point in most cases into the same direction.

**Table 3.6: Changes as results of AFTA (all manufactures) - Scenario 2**

<table>
<thead>
<tr>
<th>SCENARIO 2</th>
<th>Expenditure (in %)</th>
<th>Wage Rate (in %)</th>
<th>Exchange Rate (in %)</th>
<th>World Trade (in mn USD)</th>
<th>Welfare (in %)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Indonesia</td>
<td>0.20</td>
<td>0.97</td>
<td>-0.83</td>
<td>212.94</td>
<td>0.21</td>
</tr>
<tr>
<td>Malaysia</td>
<td>0.79</td>
<td>2.19</td>
<td>-0.39</td>
<td>273.01</td>
<td>0.97</td>
</tr>
<tr>
<td>Philippines</td>
<td>0.16</td>
<td>0.83</td>
<td>0.14</td>
<td>104.31</td>
<td>0.32</td>
</tr>
<tr>
<td>Singapore</td>
<td>1.56</td>
<td>2.82</td>
<td>2.43</td>
<td>679.57</td>
<td>2.85</td>
</tr>
<tr>
<td>Thailand</td>
<td>0.33</td>
<td>0.93</td>
<td>-1.21</td>
<td>189.16</td>
<td>0.36</td>
</tr>
<tr>
<td>ASEAN</td>
<td></td>
<td></td>
<td></td>
<td>1,458.99 (1.36%)</td>
<td></td>
</tr>
</tbody>
</table>

Source: *De Rosa, Dean A.: The ASEAN Example, 1995, p. 46.*

Table 3.7 contains simulation results for a liberalisation of all goods between AFTA members on a discriminatory basis; this simulation is principally based on the ASEAN leader’s decision of 1994 to liberalise some agricultural products and natural resource products as well. Therefore, this scenario comes closest to the proposed liberalisation under the current AFTA scheme.

**Table 3.7: Changes as results of AFTA (all goods) - Scenario 3**

<table>
<thead>
<tr>
<th>SCENARIO 3</th>
<th>Expenditure (in %)</th>
<th>Wage Rate (in %)</th>
<th>Exchange Rate (in %)</th>
<th>World Trade (in mn USD)</th>
<th>Welfare (in %)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Indonesia</td>
<td>0.21</td>
<td>1.26</td>
<td>-0.79</td>
<td>341.71</td>
<td>0.23</td>
</tr>
<tr>
<td>Malaysia</td>
<td>0.76</td>
<td>3.07</td>
<td>0.49</td>
<td>535.82</td>
<td>1.30</td>
</tr>
<tr>
<td>Philippines</td>
<td>0.32</td>
<td>0.96</td>
<td>-1.15</td>
<td>170.57</td>
<td>0.41</td>
</tr>
<tr>
<td>Singapore</td>
<td>2.09</td>
<td>6.32</td>
<td>3.18</td>
<td>992.64</td>
<td>3.86</td>
</tr>
<tr>
<td>Thailand</td>
<td>0.62</td>
<td>4.16</td>
<td>-1.96</td>
<td>405.35</td>
<td>0.56</td>
</tr>
<tr>
<td>ASEAN</td>
<td></td>
<td></td>
<td></td>
<td>2,446.09 (2.29%)</td>
<td></td>
</tr>
</tbody>
</table>

Source: *De Rosa, Dean A.: The ASEAN Example, 1995, p. 46.*

**Non-discriminatory liberalisation leads to larger welfare gains for the larger ASEAN countries while Singapore is worse off than in the case of discriminatory liberalisation. This is, however, due to the construction of the model, and may turn out differently in reality.** Table 3.8 displays the simulation results for liberalisation of
all traded goods on MFN basis. Expenditure and welfare rise sharply in all natural-resource based economies while currencies will suffer major depreciations.

Singapore is adversely affected and even suffers a decline in welfare compared to the AFTA scenario and even to the status quo. This is of little surprise if we consider that Singapore is the main beneficiary of the trade diversion effect of AFTA because it competes directly with the major industrial countries in providing exports of manufactures. In the case of MFN liberalisation, however, it is no longer the natural beneficiary of the larger ASEAN countries’ import demand. Moreover, Singapore even needs to adjust its exchange rate downward because the removal of still existing NTBs will increase its import demand. Similarly, the trade expansion for Singapore in the MFN scenario is lower than in Scenario 3 while all other countries increase their trade volumes dramatically.

In my opinion, however, the finding that discriminatory trade liberalisation would yield larger benefits to Singapore must be questioned in the light of the model construction. As mentioned earlier, DeRosa’s model is essentially static and does not take into account dynamic effects from liberalisation. If we shared the perspective of those economists who say that dynamic effects from trade liberalisation like externalities are more important than the neoclassical static effects, we might argue that Singapore could be better off in the case of non-discriminatory liberalisation, because external scale economies from trade liberalisation favour above all rich agglomerations. Singapore lies in such a growth triangle together with the adjacent Indonesian and Malaysian regions, and as we saw from the model results, Indonesia and Malaysia are better off with non-discriminatory trade liberalisation. Therefore, technological spillovers from further development within this triangle, which is likely to be more pronounced if Indonesia and Malaysia liberalise multilaterally might outweigh the loss of Singapore’s present gains from trade diversion.

Table 3.8: Changes as results of MFN liberalisation (all goods) - Scenario 4

<table>
<thead>
<tr>
<th>SCENARIO 4</th>
<th>Expenditure (in %)</th>
<th>Wage Rate (in %)</th>
<th>Exchange Rate (in %)</th>
<th>World Trade (in mn USD)</th>
<th>Welfare (in %)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Indonesia</td>
<td>3.77</td>
<td>22.91</td>
<td>-23.22</td>
<td>3,102.22</td>
<td>2.33</td>
</tr>
<tr>
<td>Malaysia</td>
<td>5.79</td>
<td>22.39</td>
<td>-11.85</td>
<td>1,263.46</td>
<td>4.87</td>
</tr>
<tr>
<td>Philippines</td>
<td>4.83</td>
<td>4.58</td>
<td>-34.73</td>
<td>1,437.61</td>
<td>4.58</td>
</tr>
<tr>
<td>Singapore</td>
<td>0.24</td>
<td>7.10</td>
<td>-6.74</td>
<td>685.72</td>
<td>-2.05</td>
</tr>
<tr>
<td>Thailand</td>
<td>5.62</td>
<td>13.59</td>
<td>-26.75</td>
<td>2,572.19</td>
<td>4.36</td>
</tr>
<tr>
<td>ASEAN</td>
<td></td>
<td></td>
<td></td>
<td>9,061.20 (8.47%)</td>
<td></td>
</tr>
</tbody>
</table>

Source: De Rosa, Dean A.: The ASEAN Example, 1995, p. 47.

The sensitivity analysis suggests that the real impact of liberalisation will heavily depend on the demand side elasticities and on the restrictiveness of non-tariff barriers to trade. The simulations yielding the results from above have been carried out under

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113 cf. DeRosa, Dean A.: The ASEAN Example, 1995, p. 38 and p. 44.
114 cf. Tichy, Gunther: Optimum Integration Area, 1992, p. 111ff, with further references.
certain assumptions concerning the elasticities of substitution in consumption between geographically differentiated products and the assumed degree of non restrictiveness of trade barriers. Without going much into detail, we should, however, give attention in which direction various assumptions may change the results.

As could be expected, the trade volume increases with the price-responsiveness of demand for traded goods. The differences in results for various assumptions are considerable: for instance, the expansion of trade in the MFN scenario under the middle value for elasticity would be around USD 9bn while it would be around USD 4.5bn if the low elasticity values are applied or at USD 11.7bn in case the high values are applied. Elasticities equally influence the extent of trade diversions and the welfare implications of the various simulations.\textsuperscript{115}

The restrictiveness of NTBs plays a crucial role in the simulations, too. The standard value under which the above reported results were obtained, was a supposed 25% increase in administered imports following liberalisation. Alternative experiments were carried out under the assumption that NTBs were less restrictive (and would therefore lead only to 10% higher imports) and under the assumption that NTBs were more restrictive, leading to a 40% increase in administered imports. Generally, the magnitude of the adjustment of economy-wide and trade variables is greater if the assumed degree of restrictiveness of NTBs is higher. However, the relationships are more complex when it comes to consider the effects on exchange rates and economic welfare.\textsuperscript{116}

\textbf{Changes in the structure of output as a result of discriminatory liberalisation (AFTA) are modest compared to those arising from MFN liberalisation.} As far as the impact of liberalisation on the sectoral structure of output in the individual participating economies is concerned, the presentation here shall be limited to general trends, due to the complexity of the model, while the DeRosa’s study contains more detailed results.\textsuperscript{117} The AFTA plan leads to sharper increases in output of manufactures than in output of agricultural and primary commodities. Prices for agricultural and other primary commodities rise in the natural resource-abundant countries in all four scenarios, while they decrease in Singapore under the three scenarios of discriminatory liberalisation. The shift in prices is largest under the MFN scenario.

The \textit{AFTA plan} leads to small increases in the production of manufactures (around 0.5%), and, to a lesser extent, in the production of agricultural goods (below 0.2%, except in the case of Thailand).

\textit{Non-discriminatory} liberalisation has more pronounced sectoral effects. Agricultural production rises between 2.3% (Indonesia) and 8.7% (Philippines) while the production of manufactures rises even more sharply between 3.7% in Malaysia and 11.6% in the

\textsuperscript{115} Further results are displayed in \textit{DeRosa, Dean A.: The ASEAN Example}, 1995, p. 51f.

\textsuperscript{116} Details can be found in \textit{DeRosa, Dean A.: The ASEAN Example}, 1995, p. 54f.

\textsuperscript{117} Details can be found in \textit{DeRosa, Dean A.: The ASEAN Example}, 1995, p. 57-67 and 81-120.
Philippines. In Singapore, the production of agricultural goods increases by 1.5% and the production of manufactures increases by 1.2% only, reflecting the increased competition in the region.

Trade expansion is much higher in the case of non-discriminatory liberalisation and reflects comparative advantage better. The trade expansion of ASEAN increases with the range of products included in the liberalisation scheme, and is usually around four times higher in the case of MFN liberalisation (scenario 4) than in the case of AFTA liberalisation (scenario 3). In the case of MFN liberalisation, ASEAN exports of primary commodities are up USD 5.9bn while exports of manufactures increase by USD 3.2bn. On the import side, the situation is reverse and ASEAN imports of primary commodities increase by USD 3.0bn, while imports of manufactures increase by USD 6.1bn. These results underlines the comparative advantage in agriculture of the natural-resource abundant countries, which turns out in a less pronounced way in the case of discriminatory liberalisation.  

3.2.4 A study by Will Martin and Koji Yanagishima, 1995

A study carried out by Will Martin and Koji Yanagishima found out, that non-discriminatory trade liberalisation yields the larger gains than discriminatory liberalisation. Static gains are relatively small but dynamic gains, increasing growth rates, capitalise and yield large benefits to liberalising economies. All types of gains tend to increase along with the number of countries who liberalise. Especially in the case of the less desirable discriminatory liberalisation, the size of the FTA is crucial. The authors of this study used a 19 region global general equilibrium model with seven goods, one of which is non-tradable, while the six exported goods are agricultural exports, raw materials exports, manufactured intermediate goods, manufactured capital goods, manufactured consumer goods and services exports. The composite non-tradable good includes all goods produced and sold domestically.

Martin and Yanagishima carried out several simulations in order to analyse the impact of trade liberalisation within the Asia-Pacific Region. The types of liberalisation considered include non-discriminatory and discriminatory trade liberalisation, while the number of the liberalising countries varies. Singapore, for the purpose of this study, is not part of ASEAN but modelled as a separate region.

Further variations take into account various types of static and dynamic gains. Static gains consist either of welfare triangles (from the reallocation of resources) only or of both welfare triangles and static gains from firm rationalisation. As far as dynamic gains are concerned, two approaches were considered. The first focuses on gains from higher

118 Details can be found in DeRosa, Dean A.: The ASEAN Example, 1995, p. 64f.
120 More details on the construction of the model are included in Martin, Will/Yanagishima, Koji: Concerted Trade Liberalisation, 1995, p. 12f.
specialisation in the production of manufactures while the second takes into account increases in output specialisation, the availability of specialised inputs and reductions in the cost of machinery investment.

The first series of simulations considers static welfare gains only and assumes constant returns to scale. It was carried out under the assumption of a concerted 50% non-discriminatory reduction in tariff rates. Like all other series of simulations, it was constructed as follows: Experiment I considers liberalisation by ASEAN countries only, while in Experiment II, the NIEs liberalise, too. Gradually more and more regions liberalise and in Experiment VI, the whole Asia-Pacific region liberalises its trade regime. Table 3.9 reports the results of this liberalisation for ASEAN, while table 3.10 shows the results for Singapore.

Table 3.9: Effects of 50% Concerted Reductions in Tariff Rates on ASEAN

<table>
<thead>
<tr>
<th>Changes in %</th>
<th>Exp. I ASEAN</th>
<th>Exp. II I+NIEs</th>
<th>Exp. III I+China</th>
<th>Exp. IV III+ANZ</th>
<th>Exp. V IV+OEA/JPN</th>
<th>Exp. VI V+NAFTA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Welfare changes</td>
<td>0.33</td>
<td>0.38</td>
<td>0.38</td>
<td>0.38</td>
<td>0.44</td>
<td>0.53</td>
</tr>
<tr>
<td>Total Exports</td>
<td>4.70</td>
<td>4.74</td>
<td>4.74</td>
<td>4.75</td>
<td>4.80</td>
<td>4.87</td>
</tr>
<tr>
<td>Total Imports</td>
<td>4.64</td>
<td>4.76</td>
<td>4.76</td>
<td>4.77</td>
<td>4.91</td>
<td>5.13</td>
</tr>
<tr>
<td>Terms of trade</td>
<td>-0.40</td>
<td>-0.36</td>
<td>-0.35</td>
<td>-0.35</td>
<td>-0.30</td>
<td>-0.22</td>
</tr>
</tbody>
</table>

Note: The ASEAN aggregate, for the purpose of this study, consists of Brunei Darussalam, Indonesia, Malaysia, The Philippines and Thailand. The NIEs (Newly Industrialised Countries) consist of Hong Kong, South Korea and Taiwan. ANZ consists of Australia and New Zealand. JPN means Japan, and OEA (Other East Asia and Pacific) consists of American Samoa, Cambodia, Cook Islands, Fiji, Guam, Kiribati, Korea P.D.R., Lao PDR, Macao, Mongolia, Myanmar, New Caledonia, Niue, Papua New Guinea, Solomon Islands, Tokelau, Tonga, Tuvalu, Vanuatu, Vietnam and Western Samoa.

Table 3.10: Effects of 50% Concerted Reduction in Tariff Rates on Singapore

<table>
<thead>
<tr>
<th>Changes in %</th>
<th>Exp. I ASEAN</th>
<th>Exp. II I+NIEs</th>
<th>Exp. III I+China</th>
<th>Exp. IV III+ANZ</th>
<th>Exp. V IV+OEA/JPN</th>
<th>Exp. VI V+NAFTA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Welfare changes</td>
<td>-0.05</td>
<td>0.03</td>
<td>0.06</td>
<td>0.07</td>
<td>0.09</td>
<td>0.16</td>
</tr>
<tr>
<td>Total Exports</td>
<td>1.10</td>
<td>1.15</td>
<td>1.17</td>
<td>1.18</td>
<td>1.20</td>
<td>1.24</td>
</tr>
<tr>
<td>Total Imports</td>
<td>0.78</td>
<td>0.93</td>
<td>1.00</td>
<td>1.04</td>
<td>1.07</td>
<td>1.21</td>
</tr>
<tr>
<td>Terms of trade</td>
<td>-0.01</td>
<td>0.05</td>
<td>0.07</td>
<td>0.09</td>
<td>0.11</td>
<td>0.16</td>
</tr>
</tbody>
</table>

For the composition of the country aggregates, cf. Table 3.9.

Static gains are small as a proportion of GDP and the study reveals that they are only significant for countries participating in liberalisation; they tend to increase as more countries join the liberalisation process. Welfare changes are quite modest in this first series of simulations, where only static effects are considered and where constant returns of scale are assumed. The liberalisation and the subsequent reduction in the price of

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121 without Singapore.
imported goods stimulates ASEAN’s imports. Further results not reported here show, that the volume of imports changes marginally in other regions, too, as a consequence of ASEAN’s liberalisation efforts. However, larger increases occur only if the regions themselves liberalise their trade. The same can be said for exports.

The increases of imports and exports of Singapore as a consequence of East-Asian trade liberalisation are less pronounced, due to the open character of Singapore’s economy. As we might naturally assume, the largest shifts occur in countries which start with a high level of protection. The results even report a small loss in welfare for Singapore. This, however, must be interpreted in the light of uncertainties concerning the share of re-exports in Singapore’s total export trade.

An increase in manufacturing productivity and efficiency gains from firm rationalisation and economies of scale have a considerable additional impact on welfare. The magnitude of these effects, too, tends to grow with the number of liberalising countries. The second series of simulations was carried out on the assumption that efficiency gains result from firm rationalisation. There is empirical evidence that such improvements occur in sectors that are characterised by internal scale economies. The authors therefore consider a rather conservative 5% increase in productivity of the manufacturing sector.122 The results of this shift are reported in table 3.11 and 3.12.

Higher productivity will have two effects on the output of manufactures. First, the output of manufactures is higher given any quantity of inputs. Second, more resources are drawn into manufacturing from other activities, leading to a further increase in output. This productivity shock has important effects on welfare, that are only partly offset by slightly worsening terms of trade. Results not reported here show, that other regions benefit from these productivity gains, too, because their terms of trade get better.

The gains accruing to the liberalising economies grow with the number of participating economies and are, in the case of ASEAN, nearly twice as large as if ASEAN liberalises alone.

**Table 3.11: Effects of 5% Increases in Manufacturing Productivity on ASEAN**123

<table>
<thead>
<tr>
<th>Changes in %</th>
<th>Exp. I ASEAN</th>
<th>Exp. II I+NIEs</th>
<th>Exp. III II+China</th>
<th>Exp. IV III+ANZ</th>
<th>Exp. V IV+OEA/JPN</th>
<th>Exp. VI V+NAFTA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Welfare changes</td>
<td>1.34</td>
<td>1.46</td>
<td>1.51</td>
<td>1.54</td>
<td>2.07</td>
<td>2.59</td>
</tr>
<tr>
<td>Total Exports</td>
<td>4.94</td>
<td>4.95</td>
<td>4.93</td>
<td>4.93</td>
<td>4.90</td>
<td>4.79</td>
</tr>
<tr>
<td>Total Imports</td>
<td>1.04</td>
<td>1.26</td>
<td>1.33</td>
<td>1.38</td>
<td>2.29</td>
<td>3.13</td>
</tr>
<tr>
<td>Terms of trade</td>
<td>-0.31</td>
<td>-0.26</td>
<td>-0.25</td>
<td>-0.24</td>
<td>-0.06</td>
<td>0.06</td>
</tr>
</tbody>
</table>

Source: Martin, Will/Yanagishima, Koji: Concerted Trade Liberalisation, 1995, For the composition of the country aggregates, cf. Table 3.9.


123 without Singapore.
Table 3.12: Effects of 5% Increases in Manufacturing Productivity on Singapore

<table>
<thead>
<tr>
<th>Changes in %</th>
<th>Exp. I ASEAN</th>
<th>Exp. II I+I+NIEs</th>
<th>Exp. III II+China</th>
<th>Exp. IV III+ANZ</th>
<th>Exp. V IV+OEA/JPN</th>
<th>Exp. VI V+NAFTA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Welfare changes</td>
<td>1.73</td>
<td>1.81</td>
<td>1.86</td>
<td>1.88</td>
<td>2.24</td>
<td>2.72</td>
</tr>
<tr>
<td>Total Exports</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
</tr>
<tr>
<td>Total Imports</td>
<td>1.36</td>
<td>1.51</td>
<td>1.56</td>
<td>1.61</td>
<td>2.18</td>
<td>2.86</td>
</tr>
<tr>
<td>Terms of trade</td>
<td>-0.40</td>
<td>-0.36</td>
<td>-0.35</td>
<td>-0.33</td>
<td>-0.18</td>
<td>-0.06</td>
</tr>
</tbody>
</table>

Source: Martin, Will/Yanagishima, Koji: Concerted Trade Liberalisation, 1995
For the composition of the country aggregates, cf. Table 3.9.

**Dynamic gains from liberalisation which increase countries’ growth rates could have enormous impacts on welfare, even if the increase of growth rates is small, because these gains compound.** The next series of experiments also took into consideration the dynamic implications of liberalisation, since empirical evidence, relating trade liberalisation with dynamic efficiency gains is strong. The authors related their parameter estimates on dynamic gains with their estimates of the comparative static consequences of liberalisation. The underlying logic is that trade liberalisation has positive effects on learning by doing and on the availability of specialised inputs. As empirical evidence suggests, the process of learning by doing is dependent upon moving into new products and achieving substantial production runs for these goods. The penetration of export markets allows even small economies to accumulate experience in the production of new products. Therefore, the authors used an export specialisation index to assess this kind of dynamic gains from liberalisation. This type of gains also grows along with the number of economies participating in the liberalisation process.

Taking into consideration the effects of concerted trade liberalisation from the first series of simulations and the effects of a productivity increase of five percent from the second series of simulations, we get a seemingly modest **growth rate** increase in manufacturing of around 0.11% or 0.2% for ASEAN, depending on the measure. These gains tend to increase slightly with the number of countries liberalising and are larger in countries with heavy initial protection. For several reasons, both measures, however, seems to underestimate these gains. Nevertheless, one must not forget that even small increases in the growth rates capitalise to enormous welfare gains. Calculations using different parameters (removal of all tariffs instead of a 50% reduction, removal of non-tariff barriers which have not been considered in the parameters used for this simulation) could entail an additional percentage point of **growth**, equalling a capitalised gain of 50% of GDP.

---

126 For instance, a one percent higher GDP growth rate would lead to a capitalised gain of 50% of GDP; cf. Martin, Will/Yanagishima, Koji: Concerted Trade Liberalisation, 1995, p. 8 and p. 21.
Gains from discriminatory trade liberalisation would in most cases be considerably smaller than those from non-discriminatory liberalisation and depend to a greater extent on the size of the agreement. The last series of simulations carried out examined the case of discriminatory trade liberalisation and the static gains arising from it. As we would expect, the results reflect the findings of other empirical studies, suggesting that discriminatory trade liberalisation leads to smaller welfare gains than non-discriminatory liberalisation. In addition to this, the finding of other studies, that gains from discriminatory liberalisation grow with the size of the bloc were reconfirmed. Only if all the countries considered become part of the trade bloc, the results begin to approximate those of non-discriminatory liberalisation. The findings of this series of simulations are reported in tables 3.13 and 3.14.

**Table 3.13: Discriminatory Trade Liberalisation - 50% tariff reduction**

**Effects on ASEAN**

<table>
<thead>
<tr>
<th>Changes in %</th>
<th>Exp. I</th>
<th>Exp. II</th>
<th>Exp. III</th>
<th>Exp. IV</th>
<th>Exp. V</th>
<th>Exp. VI</th>
</tr>
</thead>
<tbody>
<tr>
<td>Welfare changes</td>
<td>0.00</td>
<td>0.16</td>
<td>0.21</td>
<td>0.21</td>
<td>0.41</td>
<td>0.44</td>
</tr>
<tr>
<td>Total Exports</td>
<td>0.93</td>
<td>1.68</td>
<td>1.81</td>
<td>1.90</td>
<td>3.49</td>
<td>4.09</td>
</tr>
<tr>
<td>Total Imports</td>
<td>0.78</td>
<td>1.69</td>
<td>1.91</td>
<td>1.98</td>
<td>3.71</td>
<td>4.29</td>
</tr>
<tr>
<td>Terms of trade</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
</tr>
</tbody>
</table>

Source: Martin, Will/Yanagishima, Koji: Concerted Trade Liberalisation, 1995
For the composition of the country aggregates, cf. Table 3.9.

**Table 3.14: Discriminatory Trade Liberalisation - 50% tariff reduction**

**Effects on Singapore**

<table>
<thead>
<tr>
<th>Changes in %</th>
<th>Exp. I</th>
<th>Exp. II</th>
<th>Exp. III</th>
<th>Exp. IV</th>
<th>Exp. V</th>
<th>Exp. VI</th>
</tr>
</thead>
<tbody>
<tr>
<td>Welfare changes</td>
<td>0.80</td>
<td>0.85</td>
<td>0.93</td>
<td>0.97</td>
<td>0.50</td>
<td>0.43</td>
</tr>
<tr>
<td>Total Exports</td>
<td>0.80</td>
<td>0.99</td>
<td>1.09</td>
<td>1.13</td>
<td>1.03</td>
<td>1.18</td>
</tr>
<tr>
<td>Total Imports</td>
<td>1.90</td>
<td>2.13</td>
<td>2.34</td>
<td>2.43</td>
<td>1.59</td>
<td>1.60</td>
</tr>
<tr>
<td>Terms of trade</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
</tr>
</tbody>
</table>

For the composition of the country aggregates, cf. Table 3.9.

3.2.5 A study by Young and Chyc (1994)

Young and Chyc find out that the first best solution for APEC countries would be multilateral trade liberalisation. They identify losses in household utility for some APEC regions from preferential liberalisation. A surprising result, contradicting the findings of other studies, is that APEC countries are worse off by pursuing non-discriminatory liberalisation without demanding reciprocity from the rest of the world\(^{128}\) than by discriminatory liberalisation. The study, however, takes only static gains into account. Young and Chyc carried out a CGE study in a model with ten countries consisting essentially of the European Union.
regions - nine of which are APEC members with the tenth being the rest of the world, dominated by the European Union. Three commodity groups are considered: food and agriculture, resources and manufacturing, services. The authors used a post-NAFTA data set derived from the GTAP data set.

Experiments have been carried out on three scenarios. Scenario 1 examines the likely impact of an APEC Preferential Free Trade Area, where Import Tariffs and NTBs are removed on a discriminatory basis. Scenario 2 examines trade liberalisation between APEC countries based on the non-discriminatory MFN principle but the rest of the world who enjoys easier access to APEC markets as well does not reciprocate. In Scenario 3, APEC’s MFN reform is reciprocated by the rest of the world. Thus, scenario 3 provides an alternative benchmark for a multilateral trade liberalisation experiment on MFN basis.

The results obtained from this study differ somewhat from the results of the other studies quoted above. Young and Chyc argue that discriminatory liberalisation along APEC lines in Scenario 1 leaves the regions North America, Australia/New Zealand, Thailand/Philippines and Indonesia worse off in terms of household utility, due to a deterioration in the terms of trade. APEC discriminatory liberalisation even has adverse effects on real GDP in the case of North America and Taiwan - although export values increase in all participating regions, apart from the excluded rest of the world. It must be stressed, however, that these results stem from a comparative static analysis and do not include long run effects. Further, the authors sustain that North America has already experienced most from its gains through NAFTA, which are already considered in the base case.

Table 3.15: Effects of Trade Liberalisation on Welfare (in USD million)

<table>
<thead>
<tr>
<th>Region</th>
<th>Scenario 1</th>
<th>Scenario 2</th>
<th>Scenario 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>North America</td>
<td>-6,625</td>
<td>-16,745</td>
<td>-10,443</td>
</tr>
<tr>
<td>Japan</td>
<td>71,564</td>
<td>57,339</td>
<td>85,220</td>
</tr>
<tr>
<td>Australia/New Zealand</td>
<td>-205</td>
<td>-1,134</td>
<td>-159</td>
</tr>
<tr>
<td>China and Hong Kong</td>
<td>5,891</td>
<td>2,778</td>
<td>5,237</td>
</tr>
<tr>
<td>Taiwan</td>
<td>5,041</td>
<td>3,348</td>
<td>5,332</td>
</tr>
<tr>
<td>South Korea</td>
<td>8,424</td>
<td>6,894</td>
<td>9,489</td>
</tr>
<tr>
<td>Malaysia and Singapore</td>
<td>2,120</td>
<td>896</td>
<td>1,690</td>
</tr>
<tr>
<td>Thailand and Philippines</td>
<td>-4,577</td>
<td>-4,449</td>
<td>-2,795</td>
</tr>
<tr>
<td>Indonesia</td>
<td>-202</td>
<td>-1,186</td>
<td>-173</td>
</tr>
<tr>
<td>Rest of the World</td>
<td>-31,668</td>
<td>17,592</td>
<td>-6,601</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>49,763</strong></td>
<td><strong>65,333</strong></td>
<td><strong>86,797</strong></td>
</tr>
</tbody>
</table>

Source: Young and Chyc: Basis, 1994, Appendix, Table 5

Equally surprising are the results in scenario 2: In case APEC member countries liberalise trade on MFN-basis without requiring reciprocity from the rest of the world, this latter region benefits from trade liberalisation at the expense of APEC member countries. The decline in household utility in North America, Australia/New Zealand, Thailand/Philippines and Indonesia is larger than in the case of discriminatory
liberalisation, while other members still experience gains, which, however, are smaller in the case of non-discriminatory liberalisation than in the case of a preferential agreement.

The case of non-discriminatory liberalisation in Scenario 3 with reciprocity from the rest of the world is identified as the first best option, leading to smaller losses in countries that lose under the first two scenarios and to larger gains in countries that gain under the first two scenarios.
4 AFTA and the New Entrants

4.1 The Enlargement of ASEAN

The end of the Cold War has provided ASEAN with a unique opportunity of becoming a truly regional arrangement and to bring peace to South East Asia. Since the time of the Bangkok Declaration of 1967, ASEAN leaders aimed to develop ASEAN into a regional rather than a subregional organisation. However, the constraints of the Cold War era did not allow the organisation an expansion to cover all of South-East Asia. With the end of the Cold War and the Soviet Union, the geopolitical environment, however, has changed. The formerly communist countries of South-East Asia have engaged in ambitious reform programmes, aiming at market-oriented economic systems and greater integration into the global community and into world trade.

Although age-old conflicts and traditional rivalries between the region’s countries cannot be resolved within, say, half a decade, the prospects for truly regionwide cooperation and for the achievement of lasting peace in South-East Asia have never been as good. A considerable political step toward the socio-economic and cultural re-integration of the war-ravaged or isolated Indochina countries into the region and finally into the world community can be seen in Vietnam’s entry into ASEAN in July 1995 and the commitment of the regional arrangement to make Cambodia and Laos become their eighth, respectively ninth members in 1997.

The situation is less clear as far as Myanmar’s entry, scheduled to take place in 1998, is concerned, due to Western reluctance to recognise the legitimacy of the country’s government and due to concerns about its human rights record. However, the fact that Myanmar was officially granted observer-status to ASEAN in July 1996 can be interpreted as the firm commitment of the the group to pursue its “constructive engagement” and to accept Myanmar as a member at least in the medium or long term. As far as Myanmar is concerned, it shall not be subject to further considerations within this paper.

The political implications of Indochina’s integration into ASEAN will not be examined more in detail either, however important they are. Instead, the focus will be on economic implications that Indochina’s entry into ASEAN will have on the new entrants as well as on the group as a whole. Assessing these economic impacts, particularly as far as the consequences from joining AFTA are concerned, is a difficult task:

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4.2 Economic Implications of AFTA-Membership for the New Entrants

4.2.1 Assessment Problems

Although theory suggests that economic openness is the first best strategy for economies, experience in the real world is somewhat ambiguous. Depending on what theory one adheres to, one could at least come to different conclusions about the magnitude of benefits arising from freer trade or the role of trade policy in general for countries like Vietnam, Cambodia or Laos. Also, we need to differentiate between non-discriminatory and preferential trade liberalisation (AFTA). Although the present climate - in science and in practice - is much more favourable to economic openness as a key determinant in development than to infant industry protection arguments, one can also find countries with less open trade regimes and nonetheless noteworthy economic performance:

South Korea has experienced enormous growth in the past decades but it neither was nor is a textbook example of an open economy; her economic success, on the contrary, is even attributed to a large extent to learning by doing behind high walls of protection in earlier decades. In the same way, Japan’s relatively protectionist trade system, characterised more by subtle but nonetheless very efficient NTBs than by high explicit tariffs, has not harmed the country’s development for decades.

Of course, one might forcefully argue that the economic environment has changed since Japan’s or South Korea’s industrial development. As far as countries such as Laos and Cambodia are concerned, it is also true that their domestic markets would be far too small to even consider infant industry protection. Moreover, the concept of borderless factories with global sourcing and marketing activities and just in time schedules requires a liberal trade regime as a prerequisite for foreign direct investment (FDI), which, in turn, is widely regarded as a panacea against poverty in developing countries. But other economists, without questioning the beneficial effects of open trading regimes, take a more moderate position when it comes to assess the importance of economic openness and trade policy in general for development.

We also need to differentiate whether we assess the impact of implementing free trade or of joining a free trade area because outcomes differ, as we have seen in chapters 1 and 3. Depending on the magnitudes of bilateral trade relations, the composition of trade and tariff structures, results will considerably vary between the two options and between each of the countries involved. But without repeating the theoretical issues already outlined in chapter 1, some more specific problems arise in the case of the three new entrants:

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Data on the new entrants is far from reliable. Economic data and trade data on these countries are scarce and not very reliable. For instance, trade direction data in the case of Cambodia and Laos in the IMF Direction of Trade Statistics Yearbook are solely based on partner records. These partner records, however, are not necessarily complete.

As far as measures of economic growth or GDP are concerned, problems arise from parallel markets and the measurement of subsistence agriculture. In the case of Laos and Cambodia, where agriculture constitutes around one half of GDP, such difficulties in measuring production have a large impact on the reliability of available data. Moreover, as far as trade data are concerned, the considerable smuggling activities across the relatively open borders in the case of Laos and Cambodia are not measured and trade data therefore poorly reflect actual trade.

The new entrants are economies in transition and their production and trade structures are yet unstable compared to other ASEAN countries. The short track of data available does not allow to trace the development of output and trade in a way that would permit reliable forecasts for the future. Given their communist past and their involvement in deep and yet uncomplete transition processes, data do not yet allow precise conclusions regarding these countries’ comparative advantage or efficient production structures as they might have resulted from allocation mechanisms inherent to market economies.

International comparisons are difficult since each of the new entrants\textsuperscript{134} has “special features” which make differentiations necessary. Cambodia must be regarded as a special case, given its only recent return to peace and the fact that trade is still largely characterised by foreign aid flows and therefore does not necessarily reflect the same features as trade of other countries.

As far as Laos is concerned, it is a special case in the sense that it has just woken up from decades of strong isolation. There are many factors other than the question of AFTA membership that determine Laos’ future trade potential, such as the (present) lack of people with English language or export marketing skills. Even customs administrations lack qualified and trained personnel in order to efficiently handle trade.\textsuperscript{135} Other factors are the difficult access to the country from outside or even the psychological effects of decades of isolation.

In my opinion, variations of these factors have an impact on the country’s trade and its position in the world economic system which dwarfs the impacts that presently could stem from joining AFTA or from pure trade policy reform, however important the latter is. On the other hand, joining AFTA could help to create this climate of more openness which again could have positive impacts on other important factors that determine a country’s capacity to trade.

\textsuperscript{134} Although Vietnam is already a member of ASEAN, it is included when I refer to “new entrant” for practical reasons as well.

More than a basic assessment of the trade potential of Laos, Cambodia and Vietnam, can only be given once these countries will have established the basic infrastructure that is necessary for trade. Like Cambodia, Laos needs to develop even the most basic infrastructure that would allow trade to occur on an appropriate scale at competitive transaction costs. Unless these infrastructures are sufficiently available, actual trade data are only a partial reflection of the trade potentials these countries have, and conclusions drawn too early might be misleading.

My analysis here will focus on main features that determine the pattern of trade. From what has been said until now, it becomes clear that serious analysis at this stage has to be limited to some very basic features of the new entrants. Therefore, the first section tries to present the factor endowments of the new entrants in the context of other ASEAN countries. Next, we will have a look at domestic production and check whether it reflects factor endowments. A short assessment of present trade flows will follow. Particular attention is given to the present trade regimes as far as information was available. Last, all the information will be considered in order to assess what position the new entrants will probably have in an enlarged ASEAN.

4.2.2 Factor Endowments in the New Entrants

Vietnam’s rich endowment with human resources on the one hand and the relatively more abundant natural resources in Cambodia and Laos on the other are likely to determine the development of the countries’ respective comparative advantages in AFTA and in the world economy. From figure 4.1, we can see that, of the new entrants, Vietnam is best endowed with human resources. Given its low stage of development, compared to the original member countries of ASEAN, the Vietnamese economy has considerable potential for the development of a comparative advantage in the production of labour-intensive goods when it comes to take part in the intra-regional division of labour. Labour-intensive services such as tourism might equally become a major source of “export” earnings, and chances for the development of tourism in the region are bright, given the country’s natural beauties and the increased living standard in other countries in the region such as Korea or Taiwan.

The share of agriculture in Vietnamese output and employment is likely to decrease, given the limited possibilities for expansion due to the high population density and, as far as employment in agriculture is concerned, the need to rationalise farming methods as more competitive employment opportunities are likely to attract labour out of agriculture.

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136 Infrastructure within Laos is still that poor that not even a seizable domestic market exists, due to geographic segmentation.

137 cf. figure 2.1.
Figure 4.1: Population and Density in ASEAN countries

Note: Density in Singapore is 4.635 persons/sq.km.

Figure 4.2: Total surface and agricultural use of land in ASEAN


Cambodia and Laos are less well endowed with human resources, but have relatively more natural resources. Cambodia has the largest potential in agriculture of the new entrants. In Laos, only a part of the abundant land area can be used for efficient
agricultural production, given the topography of the country and a lack of infrastructure in many areas. However, generation of hydroelectric power along the Mekong River which is one of the country’s most important natural resources already might give the country some potential for trade and even a locational advantage for energy-intensive industries.

The quality of human resources is relatively high in Vietnam. Enormous efforts, however, need to be undertaken in Cambodia and Laos. As far as human resources are concerned, purely quantitative assessments could be misleading. The quality of human capital is at least equally important. Therefore, comparing some basic qualitative indicators of human capital can be helpful in evaluating the potentials of each country’s human capital base and allows inferences regarding the comparative advantage.

**Figure 4.3: Human capital: Illiteracy and primary enrollment**

An interesting result is Vietnam’s record in fighting illiteracy, nonetheless its lagging behind in economic terms. In this respect, Vietnam performs well even against countries\(^{138}\) with a several times higher GDP. Considerable efforts need to be undertaken in Cambodia and Laos, where illiteracy is still far too high. Even if their comparative advantage, as outlined above, might lie more in the production of agricultural goods, competitiveness in these sectors, which is a prerequisite for trade, requires increasing skills, too: Sustainable agricultural methods (such as integrated hydrocultural farming) in the sensible ecosystems of Indochina are more skill-intensive than environmentally harmful shifting cultivation methods which are still common.

\(^{138}\) It should be mentioned, that our whole analysis is based on the assumption, that the available data allows for cross-country comparisons.
Also, modern forms of agriculture may require appropriate use of fertilizers and technology where basic skills are equally important. The management of log production, which looks likely to play a major role in Cambodian and Lao trade (Chart 4.4) is equally skill-intensive and thoughtless practices could lead to errors with fatal consequences for these countries’ trade, given the capital-good character of forests.\(^{139}\)

**Figure 4.4: Forests and Woodland in ASEAN countries**

![Forest and Woodland Chart](chart.jpg)

Source: *World Bank: Social Indicators of Development, 1996*

Especially in the case of Cambodia, much needs to be done in terms of human resource development. Data suggest that primary school enrollment is below 50%. In this war-ravaged country, the development of basic education infrastructure for the reconstruction of the country’s human capital base is crucial if Cambodia is to have its share in the economic success of the South-East Asian region.

In all three countries, but most in the case of Laos and Cambodia, training of further skills related to economic activity such as accounting, foreign languages or technical aspects of exporting should be made available to allow these countries to successfully place their products in other AFTA and world markets.

\(^{139}\) It is however doubtful, whether Cambodia or Laos will trade logs with their ASEAN partners, because most ASEAN countries are also relatively rich in terms of forest resources. These latter might play a more important role in trade with non-ASEAN countries.
4.2.3 Economic structures in ASEAN countries

In all new entrants, but especially in Cambodia and Laos, agriculture plays an important role in terms of GDP and employment and these countries might develop a comparative advantage in the production of primary-resource based goods for the foreseeable future. However, the development of production and trade with agricultural goods should not be overrated. Having assessed factor endowments, it is worthwhile comparing the findings to the actual structure of production before analysing trade data (Section 4.2.4). Development in most countries is characterised by initially low shares of industrial output in the composition of GDP and an important agricultural sector. The next stage of development usually consists of a growth in the industrial sector, especially in light manufactures, that attracts labour out of agriculture. Therefore, a look at where ASEAN countries presently stand in their development process is helpful in making projections regarding further shifts in the structure of output that will determine the pattern of trade.

As we would expect (figure 4.5), the share of agriculture as a percentage of total GDP is lower in countries that have reached a higher stage of development.

However, Thailand and Indonesia (and also Vietnam) still employ relatively much labour in agriculture with regard to the contribution of agriculture to GDP. We might therefore assume, that the inclusion of agriculture into AFTA might enhance structural adjustment and lead to a decline in the share of agricultural employment in these countries.

Figure 4.5: The Importance of Agriculture for GDP and Employment

![Figure 4.5](image)

Note: No data on share of agriculture in total GDP available for Brunei Darussalam

Especially in the case of Thailand and Indonesia, it is likely to decline in the future as a higher level of wages and a shift to more sophisticated productions will draw production
factors out of agriculture into activities with a higher factor reward. As far as Thailand is concerned, it may either rationalise and modernise its agriculture in order to make it more productive or it will increase imports of agricultural goods from its neighbours Laos and Cambodia.

Cambodia and to a lesser extent Laos might develop a comparative advantage in the production (and trade) of agricultural products and therefore benefit from structural changes in neighbouring countries. In the case of Cambodia, rubber and logs constitute a considerable potential for trade as long as these resources are used in an environmentally sustainable way that helps preserve these resources for use by further generations as well. Since trade in agricultural goods will also be liberalised in the AFTA plan, Cambodia and Laos might emerge as preferential suppliers to the more developed countries in the region.

Growth possibilities solely based on agriculture should, however, not be overrated: First, even if better job opportunities in the more developed ASEAN countries might attract workforce out of the primary sector, higher productivity and more sophisticated technology could help agriculture in these countries maintain its competitiveness. Since demand for agricultural goods, especially food, is relatively price-inelastic, intra-regional export opportunities for agricultural commodities for the new entrants are limited. Next, we should consider that even trade in the most basic commodities requires competitive transaction costs and therefore basic infrastructure. Neither in the case of Laos, nor in the case of Cambodia, these infrastructures are presently sufficiently available.

Next, agriculture depends heavily on the weather (as does power generation in Laos, too) and some diversification of the industry and trade is therefore recommendable. Last but not least, the ecosystems of the Indochinese countries are fragile and intensive farming methods may not at all be appropriate. Logging, however, is environmentally less harmful but offers less opportunities for intraregional trade as well.

Our next considerations concern the degree of industrialisation and the structure of industrial output in the new entrants. An analysis of the share of industry in GDP shows that the new entrants are lagging behind in terms of industrial development. Vietnam, however, has already a considerable industrial sector. In Laos and Cambodia, industrialisation is still at the very beginning with shares of below 20% of GDP.

The new entrants have considerable untapped potential for growth and industrial development. Given the quality of its human capital base, Vietnam might even be well-positioned for more sophisticated production and compete for corresponding investment in such areas with its more developed ASEAN partners. Vietnam’s potentials should not be underestimated, given the size of the country (which is the second largest in ASEAN in terms of population) and its favourable location.
4.2.4 Trade flows in South-East Asia

When the question is raised whether joining a preferential trade agreement is beneficial or not, the problem lies in the determination whether the economically beneficial effect of trade creation is sufficiently larger than the economically harmful effect of trade diversion. Of course, trade diversion is less likely to happen if members of a Free Trade Agreement (FTA) already exchanged a lot of goods before the FTA comes into being, which demonstrates that trade is mutually beneficial under sound economic considerations.

Intraregional trade in ASEAN, however, represents only a relatively small portion of these countries’ trade, and in many cases, a considerable part of this intraregional trade is entrepot trade across the free port of Singapore with the rest of the world. Given the relatively high external tariffs and the low share of GATT-bound rates of some ASEAN members\(^{140}\), duty free access from AFTA member countries bear a substantial potential for harmful trade diversion.

While this issue has been pointed out in detail in Chapter 3, we now examine the trade flows of the new entrants in order to see what importance intraregional trade has to them.

Figure 4.7: Shares of Intraregional Exports in Countries’ Total Exports (1994)

Source: Author’s own calculations; data from International Monetary Fund: Direction of Trade Statistics Yearbook, 1996

Figure 4.7 shows the importance of intraregional exports as a percentage of total exports. Trade shares with APEC have also been included in the charts in order to allow to check whether free trade along APEC lines might be preferrable to free trade limited to ASEAN.

For the purpose of this and the following figures, we assume that trade with and between Cambodia, Laos and Vietnam is intra-ASEAN trade, respectively intra-APEC trade, or - with other words - that Vietnam, Laos and Cambodia are ASEAN and APEC members. For each country, the lowest segment of the column shows exports to other ASEAN countries except Singapore (ASEAN8) while the middle segment shows exports to Singapore. Both segments combined show the share of exports to all ASEAN countries including Singapore (ASEAN9). The share of intra-ASEAN9 trade decreases from left to right.

From this first static assessment of trade flows, we can draw the conclusion that Cambodian and Lao exporters focus much more on ASEAN markets than most other ASEAN countries. On the other hand, it is interesting to observe that Vietnamese exports largely reflect the same features than those of the more mature ASEAN economies: Only a small proportion of the countries exports remain inside the region, of which a considerable part goes to Singapore (from where it might be reexported again).

Trade diversion from AFTA should therefore be relatively low in the case of Cambodia and Laos, while it may be considerably larger in the other, further developed countries. We might conclude that the very low stage of development of Laos and Cambodia allows these two countries to trade on a Heckscher-Ohlin basis (inter-industry) with other, more developed ASEAN countries.
Of course, findings from these data must not be overrated: First, as mentioned before, the quality of data obtainable for Laos and Cambodia is poor, since data are available from partner records only. On the other hand, however, the more unofficial transborder transactions occur with neighbouring countries which already are or will become ASEAN members. In addition to this, inflows of goods in the time considered were still largely characterised by foreign aid in the case of Cambodia. A further feature of Laos’ and Cambodia’s trade data is that they reflect unstability over time as far as the geographical composition of trade is concerned (Figure 4.11), confirming that these countries are still involved in transition and reorientation.

In the case of imports, the situation is similar. Cambodia, Laos and Vietnam are an attractive destination for ASEAN exporters, while even the share of trade with other ASEAN countries than Singapore is considerable. Laos and Cambodia trade most with their immediate neighbours Thailand and Vietnam. Again, Vietnam shows the lowest intraregional import share of the three transition economies, and its geographic composition of trade already approaches that of other large ASEAN countries. As has already been mentioned in Section 1.1, trade of developing countries is usually inter-industry trade with industrial economies, since developing countries, which often produce the same kind of natural-resource or labour-intensive goods, have hardly reasons to trade much with each other. Therefore, it might be interesting to consider the trade shares of ASEAN trade with industrial countries. Indeed, industrial countries absorb in most cases half or more of ASEAN countries’ exports. These figures may be underestimated since Singapore is per definitionem not included in the industrial countries aggregate but a considerable part of exports to Singapore will indeed be reexported to industrial countries.

**Figure 4.8: Shares of Intraregional Imports in Countries’ Total Imports**

![Figure 4.8: Shares of Intraregional Imports in Countries’ Total Imports](image)

*Source: Author’s own calculations; data from *International Monetary Fund: Direction of Trade Statistics Yearbook*, 1996.*

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141 This aggregate consists of European Countries, including the EU, Switzerland, Norway and Iceland, as well as the United States, Canada, Japan, Australia and New Zealand.
Figure 4.9: Share of Exports to Industrial Countries of total Exports

Source: Author’s own calculations; data from *International Monetary Fund: Direction of Trade Statistics Yearbook, 1996*

Figure 4.10: Share of Imports from Industrial Countries of total Imports

Source: Author’s own calculations; data from *International Monetary Fund: Direction of Trade Statistics Yearbook, 1996*
Figure 4.11: Evolution of Intraregional Exports over time

Note: no data are available for 1995 exports from Indonesia to Singapore. 
Source: Author’s own calculations; data from *International Monetary Fund: Direction of Trade Statistics Yearbook*, 1996.

Note how much the curve is oscillating in the case of Cambodia and Laos, while in the case of Vietnam, development over the last six years was relatively stable and in line with other ASEAN countries. Whether these strong oscillations are due to the poor quality of data or whether they really reflect big changes in the structural composition of trade cannot be said. The curve for intraregional imports shows some similar features.

Figure 4.12: Evolution of Intraregional imports over time

Note: no data are available for Indonesia’s 1995 imports from Singapore. 
Source: Author’s own calculations; data from *International Monetary Fund: Direction of Trade Statistics Yearbook*, 1996.
4.2.5 Trade, Location and Infrastructure in Indochina

The location of the three newly entering members suggests that Vietnam, and to a lesser extent Cambodia, have locational advantages while the situation is more problematic for Laos. Location and infrastructure have both key roles in the development of a country. They are especially important for the development of trade: Only adequate infrastructure and easy access to inexpensive transportation and communication facilities allow goods to be produced competitively in locations far away from the point of consumption. In other words, sufficient communication and transport facilities are an undispensable prerequisite of trade, and trade has been important in the region’s economic development.

Of the three new entrants, Vietnam is mostly privileged because it has access to the sea and most parts of the country are not very remote from the coastline, whose geography allows for further development of the still poor and war-ravaged infrastructure. Therefore, the development of portuary facilities and links to the interior parts of the country are crucial factors for Vietnam’s industrial development and for its capacity to use its locational advantage for becoming a centre of international trade. Especially the coastal areas have good prospects of development, given the role that sea transport as the most inexpensive way of shipping goods over long distances has in world trade. However, infrastructure development is necessary to help develop regions with a locational disadvantage, too.\(^\text{142}\)

In this sense, the location of Laos poses some severe problems. Its locational disadvantage as a land-locked country is further reinforced by absolutely inadequate cross-border infrastructure. Its economic development is even harmed by poor interior infrastructure. So far, the friendship bridge, built between Laos and Thailand which is in service since 1994 is the country’s only satisfactory international traffic link.

Development of cross-border infrastructure will determine the role that trade will be able to play in the country’s development. Sufficient domestic infrastructure in this mountaineous country with a difficult topography is equally important if its role in the region shall not be reduced to that of a country of transit.

In this sense, the cooperation between the “Mekong Six” in the area of infrastructure is of particular importance to Laos, and its ASEAN partners should consider to take an active part in infrastructure development in Indochina, too - not only because it is in their own interest (for instance as far as trade between the larger countries Thailand and

\(^{142}\) So far, the areas close to Ho Chi Minh City (HCMC) have developed much more rapidly than other regions. While “growth triangles” or “growth poles” can create additional welfare through externalities, development should involve more remote areas as well in order to prevent excess migration pressures and environmentally and socially unsustainable development.
Vietnam is concerned) but because it is crucial for a fair and equitable distribution of the gains from free trade.\textsuperscript{143}

4.3 Trade Regimes and Trade Policy Reform in the New Entrants

\textit{Vietnam is the most active country when it comes to economic integration into AFTA and the world trade system. It is followed by Cambodia, while Laos is lagging behind.} In 1995, Vietnam joined ASEAN as its seventh member, and in 1997, Cambodia and Laos will follow. While Vietnam has already become a member of AFTA with a schedule for trade liberalisation\textsuperscript{144}, the situation is less clear for Cambodia and especially for Laos, where it still cannot be predicted when the country will be able to join. However, both countries will be given a 10-year implementation period.\textsuperscript{145}

Main difficulties of Laos in preparing for AFTA arise from a lack of trained and efficient personnel, where Laos needs help from its ASEAN partners. Another problem for both Cambodia and Laos is the contribution of USD 1mn to the ASEAN fund.

In addition to AFTA membership, Vietnam and Cambodia are presently in the process of accession to the World Trade Organisation, where all original ASEAN members are already members. Of the new entrants, Vietnam is the only country to be already a member of the World Customs Organisation (WCO). All original ASEAN countries are WCO members.

Let us now have a look at the trade regimes of the new entrants in detail. Each subsection will be dedicated to a brief presentation of the countries’ actual policies and the areas where reforms are necessary in order to join AFTA. Because information on the subject is rather scarce, standardised cross-country comparisons are difficult at this stage. Therefore, the trade regime of each country will be presented separately.

4.3.1 The Vietnamese Trade Regime

\textit{Trade policy reforms in Vietnam have been well conceived and executed. The country changed its trade regime swiftly after the collapse of COMECON.} The Vietnamese trade system before the collapse of COMECON was essentially characterised by barter

\textsuperscript{143} An example of cooperation in infrastructure development can be provided by the European Union, who is contributing considerable funds to infrastructure development in its less developed member countries such as Portugal.

\textsuperscript{144} cf. Section 2.2.

\textsuperscript{145} cf. Theparat, Chatrudee/Sawatsawang, Nussara/Thapanachai, Somporn: Free Trade, 1996.
trade with other communist countries and its execution through state trading companies. Artificial exchange rates, which did not result from price mechanisms, had been applied.

After the collapse of COMECON, the trade system was liberalised: the exchange rate was unified and devalued to the level on the parallel market, resulting in a 73% real devaluation\textsuperscript{146}, which remarkably increased the profitability of exports. Enterprises have been given the right to trade directly with foreign partners, provided they have government certification to do so. Next, most quantitative restrictions were abandoned and a duty-drawback scheme has been introduced on imports that are needed for the production of exportable goods. After all, the trade reforms carried out show that Vietnam has learnt a lot of its regional partners.

\textit{Despite the progress that has been achieved, some imperfections remain such as quantitative restrictions, various licensing requirements and, more generally, an unreliable legal framework with ad hoc changes in tariff rates.} While foreign trade is no longer restricted to state trading companies, private trading companies need to obtain government certification for foreign trade. However, these certificates are issued only if the company fulfills strict capital and turnover requirements, which limits the entry of import-export companies. Private producing enterprises, that only import what they need and only export what they produce are reported to get these licenses relatively easily.

However, such a system of licenses which keeps the number of privately owned trading enterprises down can effectively hinder imports, especially in the case of finished goods, where private producing companies may have as little interest in importing them as state-owned trading companies, that could be assumed to stand under certain influence from the government. Thus, the present system accommodates export-oriented businesses and state trading enterprises while the main burden of the restrictions lies on the consumer.

\textit{Import quotas and import permits remain despite the significant progress that has been made in this area. The remaining quotas occur remarkably often in sectors where state enterprises are dominant. The tariff system is characterised by widely dispersed rates with frequent changes and seems to be administered quite arbitrarily.} Petroleum, fertilizer, steel, cement, sugar, vehicles with fewer than 12 seats and motorcycles were subject to quotas in 1995. These quotas can be adjusted during the course of the year. Import permits were required for 15 products, including those subject to quotas. Further administrative restrictions apply for import of second-hand merchandise (machinery and equipment as well as consumer durables). \textit{Export quotas} apply to rice only, while export permits are required for shipments of oil, rice and wood products.

\textsuperscript{146} cf. Dollar, David: Vietnam’s entry, 1996, p. 3.
The tariffs of the import duty system can be quarterly changed. In March 1995, 36 different rates, ranging from 0.5% to 200% were applied. Most rates on raw materials and investment goods were below 10%, essential consumer goods were subject to rates up to 22% percent while rates applied to standard consumer goods went up to 60%. Export taxes were applied on raw materials such as rubber, crude oil, hides and shins, logs, sawn wood, unprocessed rattan, unfinished parquet boards and various metals.

The logic of Vietnam’s foreign trade regime includes some remainders of planned-economy thinking. The way in which quotas and duties are administered - especially as far as the frequent changes of tariff rates are concerned - reflects the government’s attitude toward foreign trade: While exports are encouraged because they are seen as a source of economic growth and foreign exchange, the perception of imports is different: Imports, in this logic, are regarded as necessary only if domestic production is not sufficient. Such a logic leaves no room for imports of goods which are simply more competitive than domestic production. As a result, tariff rate changes are seen as a means to balance markets. Thus, inefficient industries, especially state-owned enterprises, are protected at the expense of the consumer and at the expense of private, non-export oriented domestic producers who rely on intermediate goods as inputs, which are largely produced by state enterprises and which are subject to heavy protection.

Vietnam’s foreign trade policy is not yet built on a reliable framework but still contains discretionary measures which might deter some investors. On the other side, these discretionary measures show the government’s responsiveness to business suggestions and its readiness to cooperate with firms. However, the consumer is likely to be the one who carries the burden of these policies. Duty drawback and duty exemption schemes available to export-oriented producers show, that the government is willing to create a favourable climate for its industries.

Of course, this discretionary policy aims at the attraction of foreign investment, too: As the second largest ASEAN country in terms of population, the country has an enormous market potential. Therefore, the possibility of producing under competitive conditions for export markets (with free access to imported inputs through duty drawbacks or exemptions) combined with untapped potentials on protected domestic markets where rents can be achieved makes Vietnam undeniably an attractive and interesting target for some investors.

However, this strategy has its dark sides, too. Apart from welfare losses occurring to consumers which in the end harm the whole economy, investors in capital-intensive

147 World Bank: Viet Nam, 1995, p. 81; David Dollar (Vietnam’s entry, 1996, p.12) reports that 28 different rates, dispersed from 0% to over 100%, are applied.
sectors might find the unreliable trade policy deterring.\textsuperscript{148} Next, it is all but guaranteed that Vietnam’s trade partners are willing to tolerate Vietnam’s arbitrary policies.

A highly administrative trade system also favours the development of “iron triangles” (as outlined in section 1.2.) which are coalitions of opponents to free trade. These become harder to break up with growing rents and privileges. The rents arising from the present system are likely to grow and can seriously damage the country’s development opportunities. More generally, a discretionary system constitutes a breeding ground for corruption.

The still large number of state-owned enterprises (SOEs) and their growing importance play a key role in the country’s foreign trade regime. SOEs are favourite partners for foreign investors who are interested in setting up joint-ventures (JVs) in Vietnam. The good relations between SOEs and national authorities are channels through which foreign investors can make their voice effectively heard. In the case of inward-oriented foreign investment, investors are unlikely advocates of free trade and experience shows that the government has been willing to accommodate these investors, too. The question of SOEs will be discussed in section 5.2.

Vietnam would be better off if it developed a reliable framework for its trade policy. The present combination of restrictive rules but relatively benevolent administration allows the country both an open and a restrictive trade policy. However, it makes trade policy unreliable. Vietnam’s economic openness therefore remains basically a function of political goodwill and a means of economic planning. This somehow reflects my perception outlined in chapter 1, that the way in which rules are administered has often a larger impact on a country’s actual openness than the rules themselves.

AFTA membership will have a limited impact on the country’s trade regime. AFTA is a free trade area, where countries are free to pursue individual trade policies towards third countries. Membership in AFTA will therefore have an impact only on the intraregional portions of trade, which, as have seen shown in section 4.2.4, is quite modest in the case of Vietnam.

ASEAN countries have traditionally been anxious not to interfere too much in member countries’ policies. Especially in the case of a country with a strong sense of independence like Vietnam, which will probably soon become a key player in ASEAN, AFTA membership alone will not have much influence beyond its scope of covering intraregional trade, unless, of course, reforms regarding the portion of intraregional trade are extended to all trade, which however requires the political determination to do so and which will barely come by \textit{en passant} as an externality of AFTA.

However, the reforms that need to be carried out in the context of AFTA would be a good occasion to overhaul the trade regime more generally - by eliminating the legal

\textsuperscript{148} The question is, however, whether Vietnam already has the potential for attracting such capital-intensive investment, because its comparative advantage for the foreseeable future lies more in labour-intensive manufactures.
instruments which might still be used for increased protection and which make the system unreliable and the government’s commitment somewhat incredible, and by eliminating the magnitude of tariff rates and their dispersion. Additionally, applying the same GATT rules for customs valuation that are to be applied to ASEAN products to all imports would not only help to rationalise customs clearance but really simplify all trade.

Given ASEAN/AFTA’s present stage of development, WTO membership is more likely to impose general discipline on the country’s foreign trade policy. But outcomes would, once more, not only be a function of the rules but also of the way the country decides to administer and to observe them. The WTO is less an institution based on the Asian principles of harmony and consent but more a negotiating mechanism with precise rules and sanctioning mechanisms. It is dominated by countries (EU, US) which take a more formal and legalistic approach to trade liberalisation, and which are more bothered about safeguarding their individual interests. They are less likely to accept it if Vietnam decided to pursue a somewhat capricious trade policy than her ASEAN partners.

As a member of the World Trade Organisation, Vietnam would be required to apply tariff bindings to at least a part of her trade, and to recognise multilaterally accepted rules of good practice in many fields related to trade. Especially since the UR, the WTO has become increasingly unwilling to allow countries to accept negotiation results selectively but has focussed on a single package approach where even developing countries are obliged to subscribe to some basic principles of GATT.

Membership in the WTO and integration into the MFN system with rights and obligations may expose Vietnam more to international pressures regarding a consistent administration of its trade regime. The country would have to accept these disciplines if it doesn’t want to risk access to its important export markets, which is vital for its development and a prerequisite for attracting export-oriented FDI.

**4.3.2 Trade Policy and Trade Policy Reform in Cambodia**

*Cambodia has undertaken impressive reforms of its trading system. It has unified its exchange rate, abandoned most licensing requirements and streamlined its tariff code.* Until 1987, Cambodia’s trade was essentially trade under protocols with COMECON countries and all her trade was governed under a state monopoly.

Early steps of reforms included the unification of the exchange rate, which today moves essentially with the market rate. In 1989, the private sector was allowed to establish trading companies with maximum foreign participation of 49%. As a consequence, more than 500 such trading companies were registered by mid-1993. Five state-owned trading companies are responsible for foreign trade in major commodities such as rubber, timber, rice and fuel.
The general licensing requirement for trade was dropped in the context of a major trade reform in 1993, when the tariff code was streamlined obtaining its basic present features.

*The present import regime is characterised by four dominant tariff rates and the collection of a consumption tax at the border. Most quantitative restrictions have been removed. Cambodia’s import regime can be characterised as relatively open, although tariffs are the most important source of government revenue.*

The four basic tariff rates are 7% on raw materials, unprocessed foods and essential consumer goods, 15% on machinery, 35% on most consumer goods and building materials as well as 50% to luxury consumer goods. This category comprises cigarettes, beer and other alcoholic beverages. These four rates cover 93% of all tariff lines, with an additional 5% of tariff lines at the zero rate. The rest, 2% of all tariff lines, are dispersed and result from changes that have been made to the system in the meantime. Of course, this relative simplicity makes targeted lobbying for certain products difficult and helps in administering the import duty system efficiently.

Data on Cambodian trade is very poor and it can be derived from (incomplete) partner records only. Although the average of tariff rates is neither excessively high with 18.6% nor very low in comparison to other developing countries, the trade-weighted average tariff rate comes out at 25.2% which is relatively high. This reveals the presence of some high-tariff imports with great importance such as cigarettes or beer. Since tariff concessions are granted to re-exports (which are an important feature of Cambodian trade), this figure probably overrates the effective tariff rate.

*Duty exemptions are available for investors.* Cambodia pursues a very open and efficient investment policy. While not discriminating between foreign and domestic investors, all of them are accommodated a wide range of benefits, including duty-free imports of capital goods and of intermediate goods used in the production of exports. Duty exemptions are provided for machinery and construction goods and also for intermediate inputs, if 80 percent or more of output is exported.

*Re-exports are of great importance in the Cambodian trade regime and their handling by customs authorities is quite unusual by international standards.* Low tariff rates and weak enforcement had made Cambodia a major transit country for re-exports to its neighbouring countries. Since no official documents accompany the shipments which are believed to be re-exported and since much of this merchandise trade is illegal in the country of destination, the customs authorities have found a quite peculiar way to treat these re-exports: Estimates for the share of re-exports in imports of a certain brand are used to determine on which share of import tariff concessions are applied. It is obvious that this has introduced a very discretionary element into the Cambodian import regime, and importers are likely to try to convince customs authorities that a large share of the imports are in fact re-exports. At least one widely advertised and consumed product is treated as a 100%-re-export. The question of re-

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149 However, this apparently high rate comprises excise taxes which are equally collected on domestic goods. Thus, many products in this category even end up with negative protection.
exports cannot be overrated: in 1995, imports totalled USD 1.213mn, but almost half of it (USD 582mn) were re-exported, with “domestic” exports at only USD 265mn. In 1994, tariff revenue from re-exported imports was assumed to be 27% while it was estimated at around 40% in earlier years. However, no data are available on the loss of tariff revenue due to would-be re-exports which de facto end up on the domestic market.

Given the uncertainty of the gains from the present system as well as its high vulnerability for abuse by rent-seeking exporters, respectively importers, it might be recommendable that the present regime for re-exports be brought in line with internationally recognised practices for their treatment.

_Cambodia’s export regime is characterised by a small number of tariff lines to which modest export taxes are applied._ Export taxes presently apply to fish, sawn timber and some precious stones at rates of 10%. Since March 1995, an export ban on sawn timber is in effect. This export ban may have adverse effects on the country’s trade while it does not constitute a first best policy to tackle the environmental problems arising from excessive harvesting which it seeks to halt. (see chapter 4).

_New proposals for import tariff reforms are under way. More important, however, are plans for a more extensive use of export taxes as a an environment, trade and industrial policy instrument. These export taxes may severely limit the country’s development opportunities._ Reform proposals for the import tariff regime would bring even more tariff lines into the 7% category, making it the most important tariff rate with over half of all tariff lines. Some new, low, tariff rates would be introduced, increasing the number of different rates. The average over all tariff lines, however, would decrease to 14.2% from 18.5%. The trade-weighted average tariff rate would decrease slightly from 25.5 to 24.7%. However, a new tax (TSM) is to be introduced on some products such as petroleum in addition to the consumption tax. Since the TSM will be applied on price-inelastic goods, their average trade-weighted rate would likely increase to 27.9%.

Of greater economic impact are some reform proposals as far as export taxes are concerned. The country plans to increase the number of tariff lines subject to import taxes from 29 to 88. Moreover, unprocessed rubber shall be subject to a 22% export tax while processed rubber shall be subject to a 17% export tax. Timber is also proposed to be subject to export taxation.

While the different rates for processed and unprocessed goods show, that one aim is to promote processing in Cambodia, the export taxes can be a serious disincentive for investment in primary-based export-oriented industries. These latter, however, have been identified as the country’s key comparative advantage in these early stages of industrialisation. Further on, such high tax rates, combined with the high porosity of the border are an incentive for smuggling. Similarly to the export ban on log which we have already discussed above, this export tax is one of the more dangerous recent development in Cambodian trade policy.

_AFTA membership requires some additional reforms of Cambodia. It might be interesting for Cambodia to consider the extention of AFTA concessions on MFN_
basis. On entering AFTA, Cambodia needs to introduce two different tariff rates - one for trade with other ASEAN members, the other for trade with the rest of the world. Since AFTA is a free trade area, it may, however, make sense if Cambodia uses his sovereignty in the determination of its foreign trade towards third countries by applying the same rate it applies to ASEAN imports on an MFN basis. This would not only facilitate customs clearance (and therefore reduce administration costs), but adverse effects on the balance of payments - which may be a reason not to extend MFN treatment to the rest of the world - would be unlikely to be more pronounced.

In my opinion, such a handling would demonstrate Cambodia’s determination for economic openness with the rest of the world, and this would be a strong sign for potential investors. Unlike the larger Vietnam, Cambodia would not even have to be bothered about the potential loss of attractiveness towards inward-oriented FDI, because Cambodia is much to small in order to seriously consider infant-industry protection. Last but not least, another aspect of trade theory might be worth to be considered:

At the present stage of very low development, Cambodia’s needs for imports are not very sophisticated. This means that they can theoretically all be satisfied by other AFTA members. In other words, high protection towards third countries with low protection towards other AFTA members will not keep imports off but diverts imports from potentially more competitive suppliers away to ASEAN. I therefore regard the risk of trade diversion as high, while I judge the gains from discriminatory liberalisation (in terms of less adverse balance-of-payments-effects) as being extremely low.

To return to the requirements arising from AFTA membership, it is worth to remeber that preferential treatment of goods is based on rules of origin. Cambodia therefore needs to create some mechanisms for the administration of these rules.

Advantages of AFTA in particular lie in the field of political economy and may also be a marketing instrument for the further attraction of FDI. Membership in AFTA will make the present government’s trade liberalisation efforts less reversible, because international agreements help to overcome domestic pressure for reversal of liberalisation.

Further on, AFTA membership could turn out to be an effective marketing instrument for the attraction of FDI. First, it may be a sign that Cambodia “graduates” into the next tier of economic tigers. Mentioning Cambodia along with Singapore or Thailand as a member of the same regional arrangement may be especially useful for a war-ravaged and destabilised country. Further on, as “senior” AFTA members undergo structural change towards more capital-intensive productions, Cambodia may profit from relocations in the primary-resources or labour-intensive sectors. However, it will be competing with other countries for such investment.

WTO membership will have even more advantages for Cambodia. For a small country such as Cambodia, WTO membership is a possibility to reach MFN treatment for its goods on foreign markets that would otherwise have to be negotiated bilaterally. It gives Cambodian exporters the chance to operate in an internationally recognised
environment, and the dispute mechanisms of the WTO become accessible for Cambodia as well.

WTO membership also offers the opportunity to develop Cambodian law along international standards (such as the TRIPs) and it gives investors some type of “insurance” that the legal environment in Cambodia is reliable.

Further advantages might arise of the phasing out of the Multifibre Agreement (MFA). However, changes in this area through the UR have been ambiguous.

4.3.3 Trade Policy and Trade Policy Reform in Laos

*Information of Lao’s trade regime is not very abundant and different sources contain partly contradictory information. According to the information available, the Lao trade regime has been freed from most restrictions. The tariff structure is transparent, licensing requirements are no serious impediment to trade and the official exchange rate has been abolished.* Similarly to Vietnam and Cambodia, Laos started in the second half of the 1980s to overhaul its trade system, which, until then, was largely characterised by bilateral trade agreements with COMECON countries. These agreements were phased out with the collapse of COMECON and the breaking up of the Soviet Union. In the same time, trade in nonconvertible currency has been reduced to negligible amounts from 42% in 1988.

*The import tariff regime is characterised by six main rates and a few exceptional rates for special goods.* The general maximum tariff rate of 80% has been reduced to 40%, while a few goods remain under higher protection. Raw materials, chemicals/fertilisers, machinery for agriculture and essential consumer goods are subject to low duties of 5%. Other machinery and spareparts as well as less essential consumer goods and electrical appliances are subject to a 10% import tariff, while luxury consumer goods are subject to the 20% or 30%- rate. The 40%-rate applies to soft drinks, liquors, tobacco, detergents and processed woods. A shortcoming of the system is that some similar goods are taxed at dissimilar rates (e.g. dark chocolate is taxed at 10% while white chocolate is taxed at 30%) which makes the system unnecessarily less logical.

*A few higher rates on imports continue to apply but their removal and/or transformation into excise taxes is planned for early 1997.* A protective 50% rate applies on unprocessed vegetables and fruits, coffee, furniture, soft drinks and motorcycles) while Jeeps (60%), Cigarettes (80%), Beer (80%) and Vehicles (80-150%) are subject to even higher duties. These duties, however, shall be removed in January 1997. In order to prevent government revenue loss, the high duties on alcohol, tobacco and motor vehicles will be transformed into excise taxes. The average duty rate is 11.1%, which - in absence of further information on other trade restrictions - makes Laos’ import regime look quite liberal, compared to many other developing economies. Duties collected as percent of total imports made up 10% in 1994/5, or 12.2% if dutiable imports are considered only.
Laos recently adopted the GATT valuation rules for imports. No discretionary duty exemptions are applied. A shortcoming of the system is its lack to provide duty drawbacks to producers who export only a part of their production. The GATT import valuation system has been adopted, together with some other legislation to improve customs administration. Before, the customs administration had used officially established U.S. Dollar values which did not take inflation abroad into account, therefore leading to undertaxation and a loss of government revenue.

The World Bank reported in 1994 that tariff exemptions were granted quite liberally and without clear regulations regarding which agencies really had the authority to grant such concessions. According to this source, they had been granted by several ministries (Transport, Commerce, Finance) and even by provincial authorities. The more recent IMF publications, however, report that no discretionary exemptions are granted and, moreover, that the Ministry of Finance has no power to grant such exemptions. Nevertheless, exemptions (for instance for army purchases, for diplomats and for imports under international aid programmes) are important, and the share of duties foregone through exemptions to duties collected is 20.5%.

One of the more important shortcomings of the present tariff regime is that there are no duty drawbacks for exporters, who sell only a part of their output abroad. This gives the trade regime a clear anti-export bias because it makes exports unnecessarily less competitive. In my view, it further contributes to the undesirable segmentation of industries into inward and outward oriented industries, where the former are likely to produce less efficiently. This may create welfare losses, especially to domestic customers, and, more important, it is a breeding ground for vested interests opposing further trade liberalisation.

The country’s export regime is characterised by export duties on sales of electricity and some forestry products. Electricity sales are subject to a 20% tax of invoice value. Logs are subject to specific rates, depending on the degree to which they are processed. Rates vary between 3% and 30%. Coffee and livestock are also subject to a 5% export tax calculated on FOB value.

Other shortcomings of the Lao foreign trade regime are of more administrative nature. One of the largest problems for the Lao Customs Administration is the lack of specific training and information of its employees. The administration has some organisational shortcomings which make efficient work difficult.

One way of overcoming these difficulties would be Laos’ membership in the World Customs Organisation (WCO). The country could reap considerable benefit from WCO membership, especially as far as training/qualifications and the supply of documentation on customs matters are concerned. The same, of course, is true for membership in the World Trade Organisation, which is extremely recommendable for small countries which usually do not have enough negotiating power for successful bilateral negotiations with larger economies regarding market access.
5. Policy Implications of Trade Liberalisation in South-East Asia

The last chapter of this paper is dedicated to some other important aspects of AFTA that have not been discussed so far. The policy fields surveyed in this chapter are:
- Macroeconomic policies
- State enterprise policy.

5.1 Macroeconomic Consequences

This section examines the macroeconomic consequences of economic integration in South-East Asia. The first subsection aims at pointing out general consequences of trade liberalisation and arguments are basically not tailored to the particular question of discriminatory liberalisation. Therefore, the second subsection focuses more on the particular macroeconomic aspects of regional integration areas (RIAs). While the more general findings about macroeconomic consequences of trade liberalisation apply to RIAs, too, additional features make this issue somewhat more complicated.

5.1.1 Macroeconomic Aspects of Trade Liberalisation

There are various links between trade policy and macroeconomic policies. The immediate impact of trade liberalisation - higher import demand through lower after-customs prices and a likely loss in the government’s tariff revenue - give evidence that trade liberalisation should be seen in a more general context of fiscal policy, investment policy, state enterprise policy and other domestic policies. Although this paper has so far focussed on issues related to international trade law and on microeconomic considerations, it would be a regrettable omission to leave out the macro policies in a paper that has a deliberately broad scope. However, the presentation must be limited to some very basic linkages between trade policy and macro policies.

If the government decides to lower the tariff rates on imported goods, after-customs-prices for imported goods become lower and demand for imported goods is likely to increase. As a result, the country’s balance of payments threatens to worsen, and liberalisation may thus lead to the expletion of reserves and/or to the devaluation of the currency of the liberalising economy, because demand for foreign currency (to pay for the increased imports) will increase relative to supply of the foreign currency, unless the rise in imports is offset by a corresponding rise in exports or capital imports.

A second effect of trade liberalisation is, that government revenue is likely to shrink, because lower tariff rates lead to lower tariff revenue, unless the rise in imports is so strong that it offsets the reduction of the tariff rate.
Obviously, problems are larger in countries where
1. the difference between pre-liberalisation and post-liberalisation rates is high
   enough to entail a strong increase in import-demand.
2. tariff revenue accounts for a large part of government revenue.

As far as the loss of government revenue is concerned, it is important to consider the
intraregional trade share of imports, too. If the intraregional share of imports is high,
discriminatory trade liberalisation will affect government revenue more strongly
(because the reduction of tariffs applies to a larger part of imports) than if the
intraregional share of imports is low. Although this approach is not free of pitfalls, comparing the importance of international trade taxes for government revenue and the
intraregional share of imports may give us some indications in which countries
liberalisation (in the sense of AFTA membership) will have the largest impact on
government revenue.

Figure 5.1 The importance of international trade taxes in government revenue
and the intraregional share of imports in AFTA (1992-1994)

Methods of data collection across different sources may vary.
Note: Given the high variability of the intraregional trade share in the case of some countries (especially Laos and Cambodia), the chart is based on average figures for three years (1992-1994) for both the
intraregional trade share and the share of trade taxes in government revenue.

Obviously, this logic may serve at best as a rule of thumb; for instance, this approach ignores that the intraregional share of imports may consist of goods which are subject to lower (or higher) tariffs than
imports in general. In this case the effect on government revenue might be lower (or higher).
Moreover, this approach also neglects the difference between the tariffs applied on intraregional imports and the duties on extra-regional imports. If discriminatory liberalisation widens this gap considerably, trade diversion may be stronger and the adverse effects on government revenue, too: imports from third countries which are subject to high tariffs and therefore yield more government revenue may be substituted by intraregional imports which yield lower income.
We may reasonably assume, that the effects of trade liberalisation will be most pronounced in the budget of Cambodia, where half of government revenue stems from international trade taxes, and where the share of intraregional imports is high.

The budgets of Laos, and - to a lesser extent - of Vietnam are also likely to be strongly affected by trade liberalisation. The loss of tariff revenue will have a lesser impact on the budgets of Singapore and Indonesia. In the former, trade taxes constitute only around 1.5% of government revenue, while in the case of the latter, intraregional imports have a low share in total imports and trade taxes constitute only little more than 5% of government revenue.

Returning to the basic two problems arising from trade liberalisation - higher import demand and lower tariff revenue for the government, the following measures could help to minimise adverse impacts of liberalisation:

**Tax reform.** Countries that liberalise their trade have and that rely heavily on tariff revenue need to increase their *non-trade* tax revenue if they do not want to risk large budget deficits. Therefore, trade policy reform offers a good opportunity for a more general reform of the tax system, where policymakers should aim at the substitution of trade taxes by other taxes. Although each country will identify different fields for potential action, this tax reform should try to fulfill the following basic conditions:

- The new tax system should satisfy the country’s need for financing an efficient government on a sustainable basis.
- The new tax system should be as little distorting as possible (issue of the excess burden of taxation).

In some cases, reforms of the tax system might also require *institutional* reforms such as an expansion and rationalisation of tax and duty collection infrastructures or the rationalisation of procedures which, in some cases, may be inefficient.

**State enterprise reform.** The question of state industries is of some relevance in the context of trade liberalisation in countries where the state is a major entrepreneur. For instance, nearly half of Vietnam’s government revenue in 1994 consisted of SOE contribution by SOEs (direct taxes on SOE profits, turnover and excise taxes collected on SOE sales and non-tax revenues such as depreciation allowances and capital user fees).\(^\text{151}\) Since, however, only few ASEAN countries have important state sectors, and given the complexity of this problem, I want to discuss this issue more thoroughly in section 5.3.

For the time being, suffice it to say that SOEs could contribute through higher profitability to an increase in the government’s non-tariff revenue by an increase in efficiency and profitability. Alternatively, the state could sell its SOEs to balance transitorily the loss in government revenue by the reduction of tariffs.

**Fiscal policy reform.** The state also could use trade liberalisation and the arising need to save money as an occasion for a review of its current spending and try to increase its efficiency. Especially in growing economies with increasing employment in the private sector, cutting state expenditure by downsizing and rationalising administration can still be achieved at relatively low social costs, because workers who are laid off find job opportunities elsewhere.

**Foreign Investment policy reform.** Inflows of foreign capital can also help to a certain degree in overcoming transitional problems from trade liberalisation. A strong inflow of foreign capital can help finance the higher demand for imports. While an increase in debts may not be desirable, the attraction of foreign direct investment (FDI) is a better way to keep the balance of payment in equilibrium and to increase the capital basis for future growth. The difference between the long-run effects of FDI and foreign debts are well known and will therefore not be subject to further considerations.

FDI will also increase the country’s export potentials: If FDI is not inward-oriented but in line with comparative advantage, joint ventures between foreign enterprises and local producers are a good way to help the latter to become more competitive (if the foreign investor helps to increase efficiency by investment and transfers of know-how or technology) and to sell his products on foreign markets.

There are many ways, in which a country can successfully attract FDI. Suffice it to say that a reliable legal framework including the protection of various kinds of property rights is an asset and that economic openness without excessive local content or local ownership requirements (which deter investors) can also do a lot to sustain capital inflows.

Other measures are thinkable, too - such as the installation of export processing zones (EPZs) or tax holidays for investors. However, these latter incentives have only a small impact on investment decisions, and they are often only second best policies. For instance, there is no need for EPZs any more, if a country already has a sufficiently liberal trade policy.

**Increase in Exports.** Of course, another opportunity to finance higher imports are higher exports earnings. Exports can be increased if the state abandons restrictive export policies (export taxes, license requirements) but helps local producers to sell their products abroad by improving infrastructures necessary for exports or by providing information on foreign markets. Moreover, trade liberalisation itself will likely contribute to an expansion of exports:
Restrictive import policies have a strong anti-export bias; in order to expand exports, countries at the first stages of economic development need to import machinery and intermediate goods, whose production is skill- and/or capital-intensive and therefore not in line with the developing country’s comparative advantage. Trade liberalisation helps to import these goods at a lower price, thereby reducing the costs of exports which become more competitive.

In some cases, countries may still have opportunities to improve their trade regime: In the case of Laos, for instance, introducing a duty drawback scheme might be an incentive for higher exports. The reduction of export taxes might in some countries incentivate producers to look more actively for opportunities on foreign markets.

**Incentives for savings.** The increase in import demand as a consequence of liberalisation may be smaller, if the individuals propensity to spend their earnings on consumption becomes less due to more incentives to save money.

Ways to incentivate savings include above all the strengthening of the domestic finance and banking sector, which will again have positive repercussions on the capacity of a country to attract FDI. Tax incentives can also be of some help but their use is restricted by the government’s needs for revenue on the one hand and the costs of administering them on the other. Of greater scope for the encouragement of savings would be reforms to strengthen property rights which create better perspectives for individuals to invest their saved funds.

It also highlights once more the need for the creation of a pleasant climate and a reliable legal framework for doing business and for investment: If individuals see a real chance in starting a business of their own, they are more likely to reduce present consumption.

**Exchange rate variations and the inflation rate need to be considered, too.** Devaluations of the exchange rate can partly offset higher import demand. However, it is questionable whether they are a desirable way to resolve problems from higher import demand. In the same way, increasing money supply could temporarily finance the government’s revenue loss but would likely lead to inflation, contributing to some extent to the devaluation of the currency.

Devaluations have two effects: They make imports more expensive again, while they reduce the price of the country’s exports on world markets. As a consequence, exports will rise and imports might decrease until the balance of payments is in equilibrium again at a new exchange rate. The magnitude of this depreciation will basically depend on the two factors already mentioned initially: it will be more pronounced, if tariffs and NTBs were high before liberalisation, because the difference between the old and the new price is larger, leading to a sharper increase in import demand. It will also be higher, if demand is more price-elastic.
One might be tempted to prefer currency devaluations to policy reforms as outlined above. Although some exchange rate adjustment may be unavoidable, overall stable exchange rates should not be sacrificed when liberalisation threatens to create problems. There are many benefits of a stable exchange rate, which, in the case of the Vietnamese Dong, for instance, has taken on some symbolic value in the business community. Moreover, the problems arising from devaluation may lead to a reversal of trade liberalisation.

Currency devaluations not only increase the price of imports but they increase the general price level, too. Inflation is likely to be a consequence of exchange rate depreciations and inflation has a negative impact on savings which people are less likely to generate with increasing inflation. And because inflation is not very popular or politically sustainable, chances are that the government will seek to reintroduce barriers against free trade. Further on, devaluations bear the risks of incentivating currency substitution, which, in turn, is likely to enhance the devaluation process.

*Credibility in the government’s actions is crucial if transitory problems shall not lead to the reversal of liberalisation.* If the government, however, does not appear to be able to stand by its commitments for trade liberalisation, improvements of the legal framework believed to be temporary might induce economic actors to perceive a climate of more openness as a window of opportunity for easier imports of goods or capital outflows. Both actions, however, enforce the unfavourable movement of the balance of payments even more and therefore lead to a vicious circle where the very transitory problems increase, thus contributing to the fulfillment of the pessimistic expectations of economic actors: The government might finally really have to reverse the reforms.

### 5.1.2 Macroeconomic Aspects of Regional Integration Areas

The issues discussed so far are inherent to trade liberalisation in general. Trade liberalisation within regional integration agreements (RIAs) displays some additional features worth discussing: As we have seen in section 1.3, trade liberalisation by several countries may ease transitional problems, because terms of trade effects are less pronounced and increased import demand on the one hand is more easily balanced by better export opportunities. Besides, however, liberalisation within a restricted area only is likely to increase the interdependence between the member economies.

Easing trade restrictions between countries within a RIA is likely to lead to an increase in intraregional trade volumes and, along with it, to increased interdependence between the member states. This higher interdependence makes coordination of macroeconomic policies within an integration area highly recommendable. Therefore, it is reasonable to have a look at the present but also potential macroeconomic challenges to AFTA. It makes sense to study the channels through which macroeconomic policies usually operate and to find out whether and how

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these channels are affected if a country enters a RIA. We are then able to check if and to what extent there is a need for macro policy coordination in AFTA.

**Trade liberalisation, which entails growth in trade, requires some growth of funds.** The higher demand for funds is likely to result in some exchange rate adjustment, and the need for macroeconomic cooperation therefore already occurs at this stage: Macroeconomic policy has to smooth these exchange rate movements, because excessive exchange rate variations can endanger trade liberalisation as has been shown in the last section.

**With growing trade in goods, trade in financial services is likely to increase as well.** The increase in cross-border transactions in goods will create the need for better cross-border infrastructures in the financial sector. As long as financial cross-border transactions are hampered, the growth of trade in goods within an integration area is hindered as well.

In case liberalisation in trade with goods leads to higher trade, firms that make an increasing share of their turnover on foreign markets will create a demand for efficient financial transactions across boundaries. Some firms might also chose to hold bank accounts in different countries or in different currencies in order to smooth the effect of exchange rate fluctuations or to facilitate their daily business. Increased demand for transactions on the forward market will be another result of the growing dependence of producing firms on foreign markets. All these developments, initially driven by higher trade in goods, will lead to considerable improvements in financial structures throughout the region. These improvements, in turn, might create new demands: For instance, the presence of foreign banks makes it easier for firms and individuals to borrow (or to deposit) money in different currencies or in banks which operate under a different regulatory environment, if this is economically viable.

**Growing internationalisation of the finance sector contributes to capital mobility and is likely to lead to competition between various regulatory frameworks for the attraction of capital.** Growing international mobility of capital thus increases the need for a coordination of the regulatory environment in member countries in several fields, such as bank supervision or tax harmonisation. If there is no such cooperation, fiscal and other policies may be in danger of engaging in ruinous competition between countries and this competition might ultimately lead any fiscal sovereignty ad absurdum.

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153 An illustrating example was the introduction of withholding tax on interest earnings in Germany by its Finance Minister in 1989. This tax immediately led to enormous capital flows to banks based in other countries, especially in neighbouring Luxembourg, where regulations where more customer-friendly. The massive capital outflow has forced the minister to withdraw the tax (which was later re-introduced after some modifications). Most funds, by the way, did not end in Luxembourg banks, but in the branches of German banks, which mushroomed behind national borders.
AFTA as it stands has not yet any provisions for tax harmonisation or common rules for financial services. However, the question of free trade in services has only recently become an issue.

*With capital mobility, uncoordinated policies are more likely to lead to (undesired) cross-border effects than to the (desired) domestic effects, which they originally aimed at. Therefore, a common market with full capital mobility is likely to develop into an economic union.* Although the loss of efficacy of uncoordinated policies would be particularly pronounced in the case of fixed exchange rates, free exchange rates do not necessarily restore full macroeconomic independence. As automatically as effectively freer trade in goods will lead to freer trade in financial services and therefore higher capital mobility, as automatically will higher capital mobility set an end to the efficacy of macroeconomic policy. A common market will likely move towards the formation of an economic union with supranational monetary policy.

*Coordinating monetary policies and keeping monetary discipline are two different things.* Maintaining monetary discipline and stability may require central bank’s independence and a no-bail-out clause for fiscally troubled members. The creation of new institutions might as well be necessary to support policy integration.

On the other hand, discipline makes policy coordination easier and enhances real exchange rate stability, which is a prerequisite for the functioning of the free trade mechanism.

AFTA does not plan any measures for policy coordination. As market integration proceeds, uncoordinated policies increase both the variability of the exchange rate and the international spillovers of domestic policies.

AFTA also allows countries to introduce safeguard measures in case of balance of payments difficulties. Therefore, expectations of economic agents, that countries might finally opt out undermine the credibility of coordinated policies. This will affect their efficiency until the lack of trust in their functioning is eliminated.

*The need for the coordination of macro-policies within a regional integration area (RIA) depends on the degree of integration. AFTA does not have plans for intensive macroeconomic coordination yet.* The need for macro policy coordination is less urgent in a free trade area (FTA) or in a customs union than it is in a common market (with factor mobility) or even in a currency union.

One might therefore limit oneself to an exam of the need regarding macroeconomic cooperation within AFTA as it stands now. However, the issue is slightly more uncomfortable: As mentioned several times, it is hard for an effective RIA to stop its deepening of cooperation at a certain point; if lower tariffs are to succeed, other trade

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barriers have to fall as well (see subsection 1.3.4). If other trade barriers fall, economic interdependence grows, and if economic interdependence grows, the need for policy coordination grows. AFTA member countries should therefore be aware, that effective and credible liberalisation of their trade regime might demand from them much more readiness towards cooperation with each other in the future than they may have imagined when signing the CEPT for AFTA.

Article 5.C of the Agreement on the CEPT for AFTA says: “Member states shall explore further measures on border and non-border areas of cooperation to supplement and complement the liberalisation of trade. These may include, among others, (....) macroeconomic consultations (....).” The vocabulary chosen does not necessarily reflect member countries’ determination and desire towards coordination of macro-policies, which member countries have been reluctant to include in their plans for economic integration. Policy coordination restricts fiscal and monetary independence and, along with it, national sovereignty to a certain degree. On the other hand, it would be naive to believe that such autonomy may be maintained by not coordinating macro policies.

Figure 5.2: Efficacy of Macroeconomic Policy in Regional Integration Areas

![Efficacy of Macroeconomic Policy in Regional Integration Areas](chart.png)

Source: Nadal de Simone, Francisco: A Macroeconomic Perspective, 1995, p. 54
Figure 5.3: Efficacy of Macroeconomic Policy and the role of rules

Descretion

EMP: Efficacy of macroeconomic policy

Rules
(Institutions)


Nadal de Simone analysed some aspects of macroeconomic policy in AFTA countries. He found out that the following factors are likely to affect the implementation of AFTA:\(^{156}\)

1. Macroeconomic imbalances,
2. High and variable inflation,
3. Exchange rate misalignments,
4. Losses of fiscal revenue,
5. A lack of policy coordination,
6. Divergent views on the degree of market decentralisation and government intervention,
7. Unbalanced distribution of costs and benefits of adjustment between member countries,
8. Absence of adequate institutions,
9. Similar Factor Endowments leading to trade diversion.

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Figure 5.4: Macroeconomic Stability - Selected ASEAN countries

![Figure 5.4](chart.png)


The items taken into consideration for the calculation of the score were inflation, debt management, fiscal balance and external balance.

5.2 Trade Liberalisation within AFTA and State Enterprises

As far as the new entrants and especially Vietnam are concerned, the question of State-owned enterprises (SOEs) is of some importance in the context of trade liberalisation. However, there are more general problems involved when assessing whether the presence of SOEs in an economy is desirable or not. Policymakers responsible of the SOE reform, which might become necessary in the context of liberalisation, should be aware of this more general context as well. The question of privatisation in the context of trade liberalisation shall be discussed on the background of Vietnam, where SOEs account for about one half of budget revenue.\(^1\) I will not consider Laos and Cambodia any further, since none of them inherited a large state industry sector as did Vietnam. However, the logic may be extended to the remaining state industries in the other newly entering countries as well.

The state therefore has basically two options to make the SOEs contribute to the increased need for funds in a trade liberalisation scenario: It could either try to increase their profitability where this is possible or - even better - sell its industries. From a strictly economic point of view, only the latter option is acceptable. It makes

\(^1\) Such revenues consisted of direct taxes on SOE profits, turnover and excise taxes collected on SOE sales and non-tax revenues such as depreciation allowances and capital user fees (World Bank: Viet Nam, 1995, p. 9).
sense to recall some considerations about the state and its role in a market economy: Generally speaking, SOEs make sense only in sectors where the production cost structure (falling average costs throughout the relevant range of production quantities due to extremely high fixed costs and comparably low variable costs) would lead to a private monopoly and therefore to welfare losses (because production would occur at Cournot point with high prices and low quantities).

Therefore, two recommendations could be issued to policymakers:

1. State enterprises which do not operate in a sector characterised by cost structures leading to monopolies should be privatised as soon as possible. The scope for state ownership has generally decreased over the last decades: Some services that were formerly characterised by monopolistic cost structures (e.g. telecommunication services) can be provided under competition due to changes in production technologies (e.g. satellite communication). In the case of other services (e.g. railway), it is today often perceived as sufficient if the state provides the basic infrastructure (railtrack; fixed costs) but lets private enterprises ensure the operations (train service; variable costs) under competitive conditions.

2. If a SOE is earning profits and is operating under monopolistic cost structure (where SOEs are appropriate as to 1.), then the government is a pretty bad regulator, because it allows the company to make monopoly profits - what many governments intend to avoid by originally nationalising such firms.

**It comes clear that a government which owns a considerable share of the country’s industries gets into a dilemma: On the one hand, it is the government’s work to act as a regulator and to ensure competition in the economic sector to the benefit of the country. On the other hand, the large share of government revenue from SOE profits makes profitable SOEs a valuable asset to the government - even if part of these profits are undesirable producer rents from a lack of competition from the private sector or from protection from more efficiently produced imports.** From these theoretic consideration on the state’s role in the economy, let us return to the context of trade liberalisation.

Vietnam has remarkably high protection rates in goods where supply by SOEs prevails. Considering this high protection together with the fact that many Vietnamese state industries operate in the capital-intensive production of intermediate goods and are therefore not necessarily in line with the country’s comparative advantage

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158 The presence of SOEs makes also sense when the supply of public goods (national parks etc.) is concerned. However, most SOEs in the countries we consider produce private goods like steel or fertiliser.

159 There are two more arguments in favour of privatisation, although enthusiasm for state enterprise reform in Vietnam is gone. There is a real danger that ministries which act as producers and regulators might try to impede private competitors. Further, ministries are distracted from the work they really would have to do (cf. Dollar: Vietnam’s entry, 1996, p. 15).

160 cf. World Bank: Viet Nam, 1995, p. 82.
as identified in chapter 4, we might easily assume that these enterprises would experience some difficulty in operating in a less protectionist environment. AFTA membership would reduce tariffs in a significant way for competitors from other ASEAN countries. In the present protectionist environment, however, SOEs even manage to make profits.

While this higher profitability of SOEs may be attributed to higher efficiency, I also consider such profits - at least partly - as economically undesirable producer rents.\footnote{161}

\textit{There may be a trade-off between the success of privatisation and the results of trade liberalisation.} Let us suppose that the government tries to do what is economically reasonable: It wants to liberalise the country’s trade regime \textit{and} it wants to privatise all those SOEs whose cost structure does not require that they be run by the state. However, a dilemma arises about the sequence of action it can take:

1. It can \textit{liberalise its trade regime before privatisation is completed}. As a consequence, the profitability of SOEs is likely to decrease due to lost rents. Therefore, the revenue which the government can achieve by selling these enterprises declines tremendously, or the government may not find any buyers for its SOEs at all: Investors decide upon the profitability of an investment basically on grounds of expectations about the (long term) \textit{rate of return} that the allocation of their resources will yield. Investing in SOEs could tendentially mean investing in enterprises which are \textit{not} in line with comparative advantage and which therefore operate better in a \textit{protected} environment.

2. The other option is that the government \textit{liberalises its trade only after privatisation is completed}. This would allow the government to sell its enterprises at a higher price, or, in some cases, to find a buyer at all. In this case, however, there is a real danger, that privatisation through JVs between foreigners and SOEs leads to the creation of iron triangles as outlined in chapter 1, where the partners of a JV will make use of their linkages and good relations to the state authorities in order to exert pressure on the government to delay or abandon liberalisation, with overall negative effects on the economy.

This dilemma pointed out gives an explanation for some realities of Vietnamese policy: It explains the slow progress in privatisation and the reluctance of the government regarding fast privatisation. It also explains the reluctance of the government to liberalise its trade quickly on the one hand and its readiness to accomodate investors by the very measures which give the system its discretionary character on the other.\footnote{162}

\footnote{161}{By the way, these rents occur at the expense of the competitiveness of domestic private sector production where SOE outputs are used as inputs. Ironically, this loss of competitiveness occurs at the expense of the consumer who pays more for less efficiently produced domestic goods and who is therefore pushed to buy \textit{even more} imports of finished goods.}

\footnote{162}{Of course, other aspects may play a role, too, such as the loss of influence which bureaucrats may suffer after complete privatisation.}
Looking for a way out of this dilemma, it makes sense to recall the role of expectations. It is quite unlikely that an investor is being fooled by high present profitability of SOEs which operate in a protected environment in a country which has declared its commitment to liberalise trade, by applying for membership in the WTO and by agreeing on a liberalisation schedule within AFTA. Therefore, option 2 which is liberalisation only after privatisation will not yield much better results than option 1.

If the country is really serious about the business of trade liberalisation, or - in other words - if its actions are credible, which we assume for the purpose of this paper and for the long term good of the country, investors are likely to anticipate the loss of rents. They will therefore include their negative expectations about the development of profitability in the calculation of the price they are willing to pay for the SOE, or - more generally - in their readiness to invest into the SOE at all. Or to put it in even more radical terms: if the country’s privatisation program turns out to be a big success in terms of revenue or the enthusiasm of foreign investors who put money into SOEs, we should be suspicious about whether the country is really that serious about liberalisation.

The bottom line is, that the government should go ahead with its liberalisation programme regardless of the losses that may occur to its state enterprises. Another result of the discussion is, that one should not be too enthusiastic about the combined result of privatisation and liberalisation. The only advice to give are real reforms to foster the private sector as outlined earlier. One of these - though not the only one - is unconditional and irreversible trade liberalisation.

This will admittedly eliminate some of the SOEs, it may even reduce FDI into the country - especially the inward-oriented portions of it - unless the investment climate, regarding JVs with the private sector or private sector investment in general is further improved. We need to remember, that Vietnam is not the only country in the region to be interested in attracting FDI. It competes for the attraction of investment into labour-intensive manufactures with other countries, within the region and outside.

An open economy cannot produce outside its comparative advantage. If the country was unwilling to sacrifice a large part of the state-created industries, it would have to sacrifice economic openness, which may turn out the larger sacrifice in a globalised economy.

The only objections to such a strong conclusion might come from advocates of infant industry protection or from believers in the new strategic industry protection arguments as outlined earlier in section 1.2. Let me begin with the latter, because these may more easily be countered. As mentioned in section 1.2, the assumptions underlying successful strategic protection do not apply to developing countries, and it is extremely unlikely that somebody will invest in the foreseeable future in sectors like aircraft or spaceship construction in Vietnam.

As far as infant industry protection is concerned, the question is whether it would make sense to keep SOEs alive by liberalising explicitly (the role of expectations) more slowly, having foreign capital flowing into the SOE sector in order to gradually
modernise SOEs and to prepare them for operating in a more competitive environment. Or should we be *economistic* about the question, favour rapid change and thus *sacrifice much of the present industrial basis* on the altar of comparative advantage and radical liberalisation?

**Given Vietnam’s firm intention to join ASEAN and AFTA, practicing infant industry protection would come close to a violation of AFTA law, unless the country has included all the goods produced by SOEs in the general exception list.** (cf. section 2.2). I do not have any information on that but I suppose that most of the SOE-produced goods are equally included in the liberalisation scheme, because the AFTA scheme and countries’ inclusion lists have so far been in line with the GATT requirement that *substantially all trade* (which is at least 80% of trade) between FTA members needs to be covered by the FTA.

Another argument is that other AFTA members are unlikely to tolerate if one member country gives support to its industries which compete with industries of other members that do not provide the same kind of support - even if AFTA does not contain measures regarding industrial policies or subsidisation (which one may regard as another shortcoming of the agreement).

**Slower liberalisation might also increase the danger of creating vested interests, while fast liberalisation could eliminate much of the state sector.** A further argument against a slower liberalisation process would be that it would inevitably create vested interests and iron triangles as outlined in chapter 1 which might substantially jeopardise liberalisation efforts in the future. On the other hand, however, *fast liberalisation* as outlined above, would lead to seizable *destruction of value* through the probable *elimination* of much of the considerable state-industry sector. In my opinion, it is legitimate to ask the question whether this is politically sustainable in a poor country such as Vietnam.

**The more general question is, whether integration between highly different areas in terms of development makes sense.** Tichy (1992) remembers us that there are two conflicting school, one of which says that technological gaps which are too large may hinder development of the less developed countries and lead to polarisation effects: learning and specialization effects in the developing countries are hindered and redirected to skill intensive branches in the more developed countries.

Summarising the pros and cons of trade liberalisation in a very poor developing country with important state sectors (as found in the case of Vietnam), the question of what one perceives as good or bad depends heavily on the *theoretic angle* from which one looks at the world. And since theories have hardly taken into consideration *all* aspects of world reality, the *truth* about what’s good and what’s bad is not only hard to identify but if it exists at all, it is likely to be found somewhere in between.
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