The Impact of Liberalisation:

Communicating with APEC Communities

APEC Economic Committee Report

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Acknowledgments

In Vancouver in November 1997, APEC Leaders and Ministers requested that work be undertaken to promote community understanding of the impact of liberalisation. A broad project was conceived by a Steering Group established under the APEC Committee on Trade and Investment (CTI).

This series of papers, "The Impact of Liberalisation: Communicating with APEC Communities", was prepared as part of the broader initiative. The papers include a review of research on the effects of liberalisation, a series of case studies and a summary report.

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The author of this paper, APEC Economic Committee Report, is Robert Stranks, Department of Foreign Affairs and International Trade, Canada..

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Contents

Introduction

THIS LITERATURE REVIEW is intended to provide a short, understandable overview of the impact of liberalisation. The paper is a component of the Asia-Pacific Economic Cooperation (APEC) project entitled “The Impact of Liberalisation: Communicating with APEC Communities”.[1] The paper focuses on trade liberalisation, but it is also concerned with liberalisation of foreign direct investment (FDI). The review addresses not only the economic rationale for trade, but also the interface of trade with environmental, sovereignty, and other contemporary concerns.
Finally, the review attempts to be forward-looking and somewhat more thought-provoking than a conventional literature review.

The paper covers a lot of ground. It consists of nine sections: The Rationale for Trade and Liberalisation; What is Liberalisation; Trade and FDI Liberalisation; Assessing Liberalisation; Foreign Direct Investment; Trade and Policy Coherence; Trade and Adjustment; Trade and the Environment; and, Liberalisation, Governance, and National Sovereignty. Each of these sections is designed to contribute to a better understanding of the particular issue addressed. As the reader progresses through the sections, it is hoped that the linkages between the issues, and the complexity of conceptualising and assessing how liberalisation impacts upon our lives, will become more fully appreciated.

The Rationale for Trade and Liberalisation

The economic benefits of trade and trade liberalisation are widely recognised whether carried out unilaterally, bilaterally, or multilaterally. By improving the allocation of factors of production, trade is an important contributor to economic welfare.[2] Trade allows economies to move beyond domestic production possibilities and constraints, and in so doing, to enjoy a higher standard of living than would otherwise be the case.

The benefits of trade can be illustrated with an intuitive example. Consider two APEC economies; Korea and Indonesia. Korea has little domestic oil production, and requires imported oil from Indonesia, or other oil producers, to sustain its economic activities. Without this oil, the standard of living in Korea would fall. Conversely, Indonesia demands a range of consumer and capital goods not produced domestically, and requires imported goods from Korea, or other goods producers. Without these goods, the standard of living in Indonesia would fall. Trade thus is beneficial for both of these countries.

Another way of understanding trade is to think of it as a technology for the production of goods.[3] Let us say there are two technologies for the production of cars in Canada. The first technology involves the physical production of cars in factories in the province of Ontario. The second technology involves growing wheat in the province of Saskatchewan and subsequently exporting this wheat to Japan in exchange for cars produced in Japanese factories. While the two technologies differ in respect to inputs used, the final result is the same: Canada has the cars. Consequently, whether Canada uses the first or second technology depends on which one enables Canada to get the most cars (or to get the same number of cars with the least resources).

In a short article addressing some myths and misconceptions of trade, Paul Krugman highlighted six points to consider in understanding trade:[4]

- International trade is an economic activity like any other and can be thought of as a production process that transforms exports into imports;
- Imports, not exports, are the purpose of trade. A country benefits from trade because of the ability to import the products it wants. Exports are not an objective in and of themselves. The need to export is a burden that must be borne in order to pay the suppliers of imports;
- High productivity is beneficial, not because it helps a country compete with other countries, but because it lets a country produce, and therefore consume more. This is true in a closed economy, and it is no more nor less true in an open economy;
- Too much emphasis is put on “high-value” sectors. Trade allows all countries to benefit, not only those specialising in the “high-value” sectors;
- Employment is a broad macroeconomic issue, with policies, such as tariffs, having little net effect. Trade policy should not be debated in terms of “phony numbers about jobs created or lost”; and,
- Government support of a specific industry may help that industry compete against foreigners, but it also takes resources away from other domestic industries. International trade does not change the fact that government favour of one domestic industry will be at the expense of others.

The economic literature draws a distinction between the static and dynamic effects of trade liberalisation. The static effects may be thought of as a one-time response by firms and consumers to changes in relative prices. As national prices become more closely aligned with world prices, resources are reallocated to adjust to these price changes. Static effects are thus the benefits resulting from a greater allocative efficiency in countries undertaking liberalisation.[5]

Trade liberalisation also allows for the greater exploitation of economies of scale.[6] By allowing domestic producers greater market access opportunities, the freer market conditions allow firms to undertake greater specialised production runs that reduce the unit costs of production.[7] For countries with small domestic markets, economies of scale may be extremely important.[8] Economies of scale and specialisation in specific product lines also explain why two or more countries may all produce, and import and export, a particular good, such as shoes. Each producer can have a specific market niche. This specialisation in production, and the resulting increase in intra-industry trade (both imports and exports), however implies change for the domestic industry.

Although generally less well understood and difficult to quantify, dynamic effects are considered in the literature to be of more importance than static effects. They generally refer to increased economic growth in the medium term (such as several decades) resulting from the greater economic efficiency brought about by liberalisation.[9] This increased efficiency may stem from several factors. First, there is the facilitation of FDI flows and the contribution this investment makes to economic growth. Second, liberalisation, through increased competition from abroad, may lead to greater "X-efficiency" as producers are more enticed to innovate to remain competitive. "X-efficiency" is a term used to describe improvements in the organisation of the production process, such as management and plant layout, as well as "technology transfer" aspects.[10]

Dynamic effects can also be considered in a policy-reform or a firm-restructuring context, and how governments and firms respond to the opportunities and challenges of liberalisation. However, the difficulties of integrating dynamic variables and policy issues into assessments of liberalisation must not be understated. Data on why firms pursue a particular business strategy, for example, are often unavailable. This has led to the observation that "given the complicated nature of how dynamic variables interact and ultimately affect policy reform, it is unlikely that we will soon be capable of adding this dimension in specific modelling endeavours in the near future."[11] In general, the economic literature recognises the complexity and uncertainties of identifying the benefits of liberalisation, but these qualifiers are often expressed in technical terms. The public therefore should interpret specific economic studies on the benefits of trade liberalisation as indicative assessments, rather than precise quantitative estimates.

Thus, the benefits derived from

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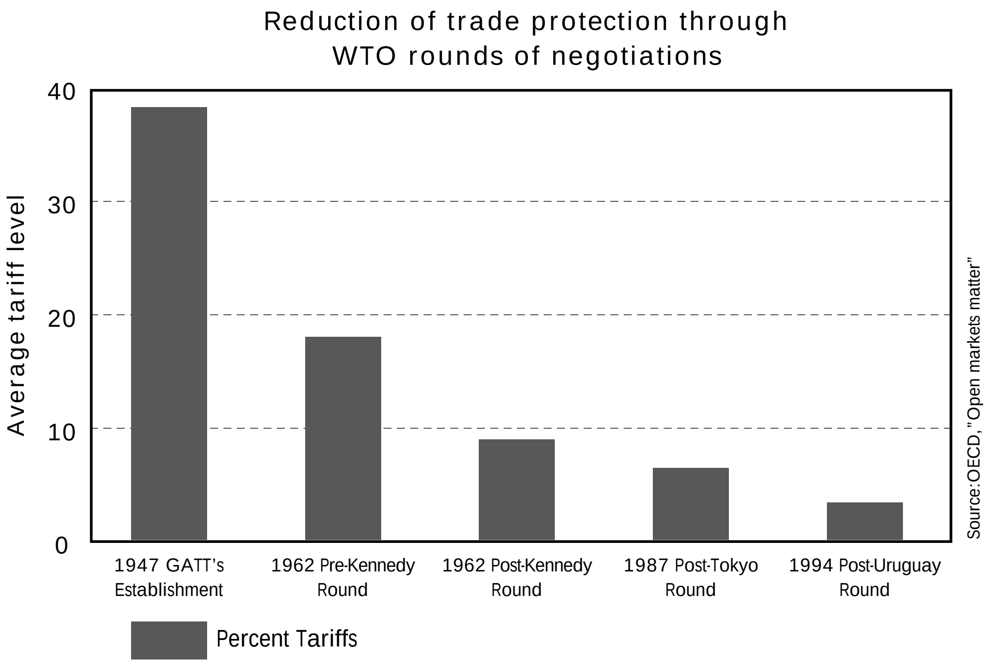

Undertaken in a bilateral or multilateral context, trade liberalisation will reduce uncertainty.

trade liberalisation arise from several sources and, as indicated in the above paragraphs, can be conceptualised in various forms. The reduction or elimination of barriers to trade encourages firms in countries to produce and trade goods and services in which they have a comparative advantage.[12] Economies will concentrate on goods and services that they produce efficiently,[13] and trade these goods and services for what they produce less efficiently.

Trade liberalisation also increases competition in both the foreign and domestic markets. This implies that firms will need to respond faster to changing market conditions. Greater competition is likely to provide an incentive for firms to increase their economic performance through cost-saving innovations and to enhance the quality of their products. More competition also leads to lower prices for consumers.

Finally, trade liberalisation undertaken in a bilateral or multilateral context, and which establishes clear trading rules, will reduce uncertainty. Without such rules, a country may face unilateral actions from its trade partners. The reduction of uncertainty, while providing more stable access, will also allow firms to make more informed business decisions.

In short, an economy under autarky, or one with no international trade, that must domestically produce all that it consumes, forfeits the economic gains (and social benefits) that are realised through international trade.[14] Trade, and the liberalisation to make trade possible, are positive propositions.

What is Liberalisation

To understand the benefits of trade, an understanding of the characteristics and institutional context of trade liberalisation is required. The focus will be on the multilateral trading system.[15] The most visible trade barrier is the tariff.[16] Within a multilateral context, first with the General Agreement on Tariffs and Trade (GATT) and then with the World Trade Organisation (WTO), tariffs have fallen considerably over the past 50 years.[17] On a regional basis, in the case of the European Union (EU), intra-EU tariffs have been eliminated. Generally, tariffs are higher in developing countries than in developed countries.[18] The GATT's Tokyo Round expanded the scope and depth of trade negotiations – moving inside the border – and included agreements on subsidies and on government procurement.[19]

Government procurement illustrates that when considering the degree of market openness, it is necessary to address more than just tariff levels. Government procurement is the purchase of goods and services by governments.[20] It becomes a trade issue in the context of the market access foreign suppliers have to government procurement, as governments' purchasing decisions can significantly influence trade opportunities as well as investment decisions. Procurement policies that favour domestic producers can be considered non-tariff barriers and are, in effect, protectionist, thus reducing efficiency.[21] International agreements on government procurement have been negotiated with the aim of reducing the practice of favouring domestic producers over foreign suppliers. Government procurement is estimated to represent 10-15% of GDP, thus open access to this market is a significant trade issue.[22]

Subsidies, either for domestic production or for exports, have long been recognised by governments as often having trade distorting effects and requiring multilateral discipline.[23] To this end, a complex set of rules in the GATT, and clarified and elaborated in the WTO's Agreement on Subsidies and Countervailing Measures and the Agreement on Agriculture, have been negotiated.[24] A number of key issues, particularly domestic support and the use of export subsidies for agricultural products, which amount to billions of dollars each year, and the trade effects of such subsidies remain. A WTO multilateral negotiation on agriculture is due to start before the year 2000. Many of the subsidy trade liberalisation issues are likely to be addressed in this negotiation.

The Uruguay Round of GATT negotiations, which resulted in the establishment of the WTO, further expanded the multilateral trade rule framework to include the negotiation of rights and obligations pertaining to agriculture, trade in services, trade-related investment measures (TRIMS), and trade-related intellectual property (TRIPS) (such as patents, copyright and trademarks), in addition to reviewing and expanding GATT rules and market access opportunities for goods.[25] TRIMS include such measures as local content requirements and export performance requirements. Local content requirements specify that the production process must use a certain proportion of inputs that are produced in the host country, while export performance requirements specify that a firm must maintain a minimum volume or value of exports. Multilateral discipline on TRIMS influences business decisions on the location of investment and production.[26] The Round's results also took steps to phase out certain quantitative restrictions, the use of which in the view of the trade policy community, tends to offset the effects of tariff reductions.[27]

Recognising the importance of services to the world economy, and the need for a set of rights and obligations for trade in services, the GATT contracting parties negotiated trade in services during the Uruguay Round. With the entry into force of the WTO in 1995, the General Agreement for Trade in Services (GATS), one of

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the legal texts of the WTO, also came into effect. Services are an important component to the economy and trade[28] since they cover a wide range of economic activities, including banking, insurance, transportation, and telecommunications.[29] Services account for more than two-thirds of total employment and GDP in most of the OECD countries, and a significant share in all of the APEC economies.[30]

World trade in services has risen substantially from 1986-1996, but is still small relative to trade in goods.[31] In 1986, world exports of services were about 400 billion in US dollar value terms compared to 1.26 trillion in 1996.[32] For goods, exports represented around 2.2 trillion each in 1986, and were about 5.4 trillion in 1996. From 1986 to 1996, the share of world trade in services (exports and imports) in total world trade increased by 2 percent from 17% to 19%.

The GATS aimed to extend the multilateral rules for the trade in goods to trade in services. The GATS was essentially concerned with liberalising markets for trade in services. The Agreement has three key elements: 1) a basic framework agreement that includes obligations and disciplines; 2) several Annexes that set out special rules for specific services (such as on air transportation services and financial services); and 3) schedules that set out each Member's specific market access commitments.

The GATS also defines four modes of supply for services: 1) *cross-border* – services supplied from the territory of one Member into the territory of another Member; 2) *consumption abroad* – services supplied in the territory of one Member into the consumers of another Member; 3) *commercial presence* – services supplied through any type of business establishment of one Member into the territory of another Member; and 4) *presence of natural persons* – services supplied by nationals of one Member in the territory of another Member. The concept of trade in services or service transactions is somewhat more complex than trade when thought of in relation to goods. The GATS, therefore, substantially broadens the economic activities influenced by multilateral rules pertaining to the international trading system.

It should be noted that there are severe data weaknesses with respect to services and consequently with estimating the effect of liberalisation of services. Cross-country data on the magnitude of barriers to trade in services do not exist. A characteristic of services is that since they tend to be intangible, barriers to trade do not appear as tariffs. Rather, regulatory measures may intentionally or not act as barriers to trade. Many observers have commented that the nonexistence of tariffs and the complex nature of regulatory regimes and their influence on services greatly complicates analysis or negotiation of liberalisation of services.[33]

Dispute settlement is another

important aspect of trade liberalisation.[34] Without an effective dispute settlement mechanism, trade liberalisation measures become less secure and predictable for producers. Yet the dispute settlement mechanism, while significantly different in nature than a tariff, also influences a firm's production decisions and how it approaches international trade. In considering the benefits of trade liberalisation, capturing the benefits of dispute settlement and rules for such practices as anti-dumping measures, is extremely difficult. The literature generally recognises that a predictable and transparent global market place with an effective dispute settlement mechanism is beneficial to importers, exporters, and consumers.

Multilateral discipline is particularly important for smaller economies that do not have the economic power to resolve conflicts through bilateral means. This is a useful perspective, as some members of the public consider the multilateral trading system to be only in the interest of the largest economies. On the contrary, while of interest to all economies, smaller economies stand to lose the most from its deterioration.

Trade liberalisation is also intricately tied to the trade blurring or "new" trade-linking agenda. There is no consensus as to what the scope of these linkages, or "new" trade issues, are or should be.[35] As a practical matter, the WTO has not turned a blind eye to the "new" trade issues. While the WTO does not at present have a mandate to negotiate such issues, its Members see a need to more fully understand the relationships between trade and other policy areas. Soon after its creation in 1995, the WTO formally established a Committee on Trade and the Environment, and at its Singapore Ministerial Conference in 1996, the WTO agreed to create Working Groups on the relationship between trade and investment, and trade and competition policy linkages.[36]

The Singapore Ministerial Declaration also called upon the WTO Council for Trade in Goods to "undertake exploratory and analytical work, drawing on the work of other relevant international organisations, on the simplification of trade procedures in order to assess the scope for WTO rules in this area."[37] While there is no consensus in the WTO on the meaning of "trade facilitation", this work involves information collection, documentation requirements, policy dialogue, and the harmonisation or mutual recognition of official processes, such as how to designate the origin of an import. The general objective of trade facilitation is to remove administrative burdens to trade and to make the conduct of trade as clear and simple as possible.

Liberalisation is also applicable to investment, where a range of measures may impede FDI.[38] Institutionally there are a large number of bilateral investment agreements, as well as in more recent years, investment provisions in regional arrangements. There is, however, no multilateral investment regime comparable to the legal and institutional structure of the WTO. The members of the OECD began negotiations on a Multilateral Agreement on Investment (MAI) in 1995. The intent behind this initiative was, and remains, to create a comprehensive multilateral framework for international investment. Cornerstones of the MAI are the principles of National Treatment and Most-Favoured-Nation (MFN). These principles require that investors from foreign countries be treated fairly and on an equal basis as domestic investors. The agreement, which has yet to be finalised, recognises that countries have specific investment sensitivities, and allows national reservations or exceptions to the basic rules of the MAI. The MAI is intended to be a free-standing agreement, open to accession by non-OECD members.

Trade and FDI Liberalisation[39]

Trade and FDI are interrelated activities. Two sets of links between trade and FDI are highlighted in the literature. The first is the impact of trade policies on FDI. The pattern of trade and trade policies may influence the size, direction and composition of the FDI flows.[40] Trade policies, such as tariff barriers, can also serve as incentives to FDI inflows, intentionally or inadvertently.[41] The interest in jumping a high tariff, for instance, can induce foreign direct investment in the local market. Regional trade agreements and multilateral liberalisation may also influence FDI decisions of firms.[42] Larger market size, resulting from liberalisation for example, provides opportunities for investors to take advantage of economies of scale and therefore encourages investment flows.[43] Rules of Origin, which distinguish between products produced by countries party to the regional agreement and those that are not, also may induce third country investment.[44]

The second set of links is the impact of FDI on trade. FDI policies, by affecting investment decisions, influence the size, direction and composition of trade.[45] FDI can have significant and dynamic effects on the host country receiving the investment as they stimulate capital formation, competition, innovation, and productivity.[46] All these factors can impact on a country's import and export activities. Several studies, covering a number of sectors, confirm a positive relationship between FDI inflows in the host country and the total volume of host country's exports.[47]

There is some evidence to suggest that in general affiliates of multinational enterprises (MNEs) have a higher propensity to export than locally-owned firms. MNEs often have better knowledge of the international market and can respond more quickly to changing international demands.[48] The size and efficiency of their distribution network may also give foreign firms an advantage. Several studies also show that foreign affiliates can have a positive spill-over impact on the export propensity of local firms.[49] Export performance may also be mandated through FDI policy. Investment policies, such as those setting a mandatory requirement to export a certain portion of the local production[50] and/or FDI policy biased towards export-oriented sectors, are designed with export promotion in mind (TRIMS).[51]

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The evidence on the relationship between FDI and imports is mixed. Some studies indicate that the inflow of FDI reduces host country's imports[52], while other studies find that inward FDI raises host country's import levels.[53] Affiliates often have a high propensity to import intermediate inputs from the home country, particularly when such inputs are either not available in the host country or the quality of the local supplies is not acceptable.[54]

An important question is whether FDI is trade-enhancing or trade-substituting. A study by Investment Canada shows that the foreign owned manufacturing affiliates in Canada display higher import and export propensities and are more outward-oriented than their domestic counterparts.[55] The finding indicates that, in the Canadian case, foreign affiliates are not trade-substituting agents, but rather trade-enhancing. The study concluded that intra-firm trade (for which FDI is a precondition) has played a significant role in Canada's economic development.

Assessing Liberalisation

There is a substantial amount of literature on trade theory, trade policy, investment, and the costs of protection and the benefits of liberalisation. Two particularly readable and insightful documents addressing liberalisation have been written by the World Bank and the International Monetary Fund (IMF).[56]

The World Bank document considers liberalisation from the perspective of the challenges it raises for workers in an integrating global economy. The document concludes that international trade generally benefits workers because:

- It gives firms access to much larger markets in which to sell their products therefore removing constraints imposed by domestic demand. In particular, it allows firms to specialise and to upgrade production on the basis of global demand;
- It has been strongly associated with poverty reduction in most developing countries; and
- It allows workers access to consumption goods where they are cheapest, and permits firms to purchase capital goods with the latest technologies. The rapid industrialisation in East Asia has been to a large extent built on imports of Western technologies and machinery.

The document also highlights that liberalisation involves change in policy responses:

- Economies must undergo often painful adjustment if they are to reap the benefits of trade, especially if their economies have been heavily protected. Changes in the pattern of trade bring about social transformations negatively affecting workers who lack the flexibility or the skills to leave sectors previously supported by trade barriers;
- Since society as a whole gains, the challenge for policy makers is to facilitate transition to freer trade by upgrading the skills of the labour force, and to avoid protection.

The IMF document takes a growth strategy approach to its analysis of liberalisation, and reaches similar conclusions:

- With respect to developing countries, the performance of the outward-oriented economies has been superior to that of the inward-oriented economies where tariff and non-tariff barriers have been high and where there has been a bias against exports in favour of import substitution;[57]
- The costs of trade restrictions and isolation from the competitive forces of world markets are amply illustrated by the former centrally planned economies. Decades of central planning, including managed trade, resulted in unproductive investments and an obsolete capital stock; and
- Most developed countries have in place complex policies to protect domestic agriculture. These policies are extremely costly, and

Liberalisation raises challenges for workers in an integrating global economy.

The Philippines' Experience

The Philippines embarked on a series of trade policy reforms in the 1980's in response to a rapidly changing global economic environment. Encouraged by the success of other developing economies who adopted an outward looking orientation, trade liberalisation was earmarked as the fundamental element in injecting dynamism into the industrial sector.

A recent study explores the impact of the Philippines' Trade Policy Reform (TPR) on the manufacturing sector, particularly eight industries: textiles and garments, motorcycles and parts, meat and dairy processing, appliances, packaging, synthetic resin and plastic, agricultural machinery and shipbuilding/repair and boat building. The study offers empirical evidence on the importance of trade policy reforms in shaping industrial efficiency and performance.

The study illustrates that the trade policy reforms positively affected the manufacturing sector. Heightened competition became a catalyst to the improvement of efficiency levels. The trade policy reforms reduced entry barriers, consequently providing firms with relatively greater access to supply and lower import prices of capital equipment and other inputs to production. In turn, the reduction in entry barriers encouraged new players, particularly, small and medium size enterprises. Unlike the pre-reform period, which was characterised by a high-degree of concentration due to government protectionist policies and industry specific privileges, the post-reform period was marked by a substantial reduction in market concentration that was brought about by a shift in the structure of industries to small and medium enterprises. The shift in size structure of industries was consistent with, if not directly attributable to the improvement in allocative efficiency and a more desirable pattern of resource flows.

Medalla et al, Catching the Next Wave*, Vol. II, Makati: Philippine Institute for Development Studies, 1996.*

influence production, employment, consumption, and trade.

In the last year, four particularly important studies addressing the effects of liberalisation have been published. These are the Organisation for Economic Co-operation and Development's (OECD) *Open Markets Matter: The Benefits of Trade and Investment Liberalization*, the Asia-Pacific Economic Cooperation (APEC) Economic Committee's *The Impact of Trade Liberalization in APEC and The Impact of Investment Liberalization in APEC*, and an Australian Government study entitled *Trade Liberalisation: Opportunities For Australia*.[58] Taken together, these studies provide a comprehensive and insightful understanding of the impact of liberalisation.

The OECD study takes a multidisciplinary approach and synthesises a large amount of work undertaken by that organisation, and elsewhere, largely over the past few years. The core message of the study is that, on balance, trade and investment liberalisation in the long-term is beneficial to society.

The study gives a balanced assessment of the strengths and weaknesses of trade, including drawing attention to the fallacy of "exports are good and imports are bad" argument. Trade liberalisation influences both imports and exports. Access to low cost imports, for example, plays an important role in enhancing consumers well being, as well as allowing domestic firms to have access to competitively priced inputs.

The study also highlights foreign investment as a central pillar of globalisation. Over the past decade, FDI has become a significant instrument in integrating economies. The study addresses both inward and outward FDI, and the benefits associated with such investment. FDI outflows in particular must be thought of in a dynamic sense. Outward investment allows firms to broaden their investment choices and contributes to increasing their competitiveness. Moreover, for certain firms, such as professional services or retail trade, outward investment may be the only commercially practical option.

The Impact of Trade Liberalisation in APEC study concludes that implementation of envisaged trade opening measures by APEC members will bring substantial economic benefits.[59] The study results indicate that the real GDP of APEC economies as a whole will be raised about 0.4 percent, in other words, a permanent increase of US $69 billion per year in 1995 prices.[60] The corresponding benefits to the world as a whole would be US $71 billion in 1995 prices, or 0.2 percent of global output. The APEC liberalisation impact of 0.2 percent is equivalent to one fourth of the estimated full impact of implementation of the Uruguay Round results (0.8 percent of global GDP).

The APEC study suggests that all APEC members gain from increased liberalisation, however, differences do occur and which reflect such considerations as the relative size of the economies (the larger the economy, the larger the gains in dollar terms) and the degree of liberalisation undertaken (economies that liberalise the most gain the most).[61] The results indicate that, in percentage terms, all of the developing and newly industrialised economies will gain more than the APEC average of 0.4 percent of GDP, while among the five industrialised APEC members, only New Zealand will exceed the APEC average gain, all other things equal.

Of particular note is the study's distinction between trade liberalisation and trade facilitation. The impact of trade facilitation, such as streamlining customs procedures, exceeds that of trade liberalisation, such as tariff reductions. Trade facilitation creates a gain of about 0.26 percent of APEC GDP (or about US$45 billion), while the gain from trade liberalisation is 0.14 percent of GDP (about US$23 billion).

The Australian Government study assessed the impact of trade liberalisation in Australia from the mid-1980s. The study found that liberalisation had a positive impact and contributed to a stronger industrial base, export growth, and access to the latest technologies. In regard to globalisation and trade, the paper observes that globalisation continues regardless of Australia's policy choices, and that trade liberalisation tends to be a scapegoat for the adverse effects of a range of changes in the

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Protectionism is not a viable long-term strategy for improving living standards.

way people live. The key messages of the paper are that: tariffs create distortions in production and consumer prices; contrary to popular perceptions, tariffs cannot guarantee long-term job security; more exports mean you can afford to import more, and thus benefit from a wider range of imports at generally lower prices; trade liberalisation creates losers as well as winners, as resources are channelled to more productive uses; and, progressive trade liberalisation over more than a decade has served the Australian economy well.

The paper concludes that Australia has benefited substantially from trade liberalisation, despite significant short term adjustment costs.[62] It also concludes that trade liberalisation alone will not solve Australia's economic problems or magically deliver a prosperous future, but that trade liberalisation is a big part of the answer to continued Australian prosperity. Effective policy must involve trade liberalisation and a range of coordinated policies, such as labour market flexibility.

The Institute for International Economics has published a number of books that explore the cost of protection in a number of countries. Hufbauer has summarised the results of this research on the cost of protection.[63] A major conclusion is that there are considerable costs associated with maintaining production and employment in protected sectors, and that for every job "saved" consumers pay a significant price, sometimes in the hundreds of thousands of US dollars.

The Institute's work indicates that trade barriers on agricultural and industrial goods still impose major costs both on developed and developing countries.[64] High protection and large consumer costs in each country are usually concentrated in a handful of industries, such as in the agricultural sector. For example, in the case of Korea, the study notes that protection is highly concentrated on labour-intensive agriculture and light industry, with the result that the percentage of the work force shielded by trade barriers is high compared with the figures for United States or Japan. Consequently, each country faces unique structural adjustment challenges.

These studies and others conclude that protectionism is not a viable long-term strategy for improving living standards.[65] Attempting to maintain a status quo industrial structure in the face of global change is a short-sighted strategy. Although high tariffs and levels of protection insulate domestic producers from competition, overtime, as international competitors increase productivity, the gap between domestic and foreign producers grows. So too will the gap in living standards. Moreover, the longer protection lasts the more difficult it becomes politically to liberalise as the adjustment shock to domestic producers will be greater.

Indeed, these studies support

Adam Smith's observations made in 1776 on the competitive effects of protectionist trade policies, "By restraining, either by high duties, or by absolute prohibitions, the importation of such goods from foreign countries as can be produced at home, the monopoly of the home market is more or less secured to the domestic industry...".[66]

A case study approach has also been used to analyse the impact of trade and investment liberalisation. Case studies, while focusing on a specific industry or even a firm, allow for direct consultation with business and consumer interests to obtain data and opinions on the costs and benefits of a policy change.

The Pacific Economic Cooperation Council (PECC) recently published two sectoral case studies that provide overviews and analysis of the impacts of liberalisation. The first, *Switching On – The Effects of Liberalisation in Asia's Electronics Industry* considers the electronics sector in China, Indonesia, Malaysia, and the Philippines, and discusses how trade liberalisation and openness to capital flows has encouraged specialisation of production and changed the product mix in these economies.[67] The study notes that a contributor to the growth in output in all these economies has been the inflow of foreign capital, which has intensified competition in domestic markets, promoted the growth of exports and accelerated the transfer of technology to local producers. Consumers have also directly benefited from liberalisation, from lower tariffs on imports, and from greater competition which has led to lower prices, higher product quality and a wider product variety.[68]

The second, *Pulling the Threads Together – The Effects of Liberalisation in Asia's Textile and Clothing Industry*, illustrates the likely pattern of trade to emerge in a more open environment. Among the four economies studied, China and Indonesia are more likely to develop an integrated industry, while Malaysia and the Philippines are likely to specialise in niches within the industry. It concludes that for each economy there will be an increase in two-way trade. The paper also highlights the role that foreign investment plays and how it has facilitated adjustment in the industry.[69]

The counterfactual – what would have been the repercussions of a collapse of the Uruguay Round of trade negotiations – has also been addressed in a World Bank paper.[70] The unanimous conclusion of this analysis is that countries would not only have lost the benefits coming out of the Round, but that a failure could have rolled back gains already made, and raised protectionist pressures. Such a development would have been particularly harsh for the economies in transition, whose economic reform is being facilitated by access to open global markets.

A contributor to the growth in output in all these economies has been the inflow of foreign capital.

Foreign Direct Investment

FDI is not simply an international transfer of capital, it is also an extension of a firm, including some degree of its entrepreneurial and management skills, into a foreign country.[71] Increases in flows of FDI have contributed to greater economic integration. Global firms are enterprises that have adopted global corporate strategies to increase their efficiency. Global firms establish production facilities on an international basis, pursue strategic alliances with foreign firms, and obtain inputs for production internationally.[72] The literature reviewed recognises that FDI can have a range of positive affects, such as employment creation,[73] physical capital formation[74] and domestic investment,[75] human capital development,[76] transfer of technology[77] and increased productivity,[78] and finally, economic growth.[79]

FDI is not only important for goods, but also for services. Hoekman observed that many services are not tradeable, in the sense that cross-border interaction or the temporary physical movement of providers and consumers is not enough to make a transaction feasible.[80] The long-term physical presence of producers may be required, that is, engaging in FDI. Not surprisingly, investment in services accounts for a large share of the total stock of inward FDI in most host countries. Since the early 1990s, some 50 percent of the global stock of FDI has been in the service sector. The share of annual flows of FDI to many countries has been over 60 percent in recent years.

In 1997, the APEC Economic Committee published a study on the impact of investment liberalisation in APEC.[81] The study draws on case studies from several APEC economies (Canada, Chile, Korea, the Philippines, and Chinese Taipei) and sectors (semiconductors, retail trade, telecommunications, and financial services) and derives lessons about the process of liberalising investment.

FDI is not only important for goods, but also for services.

The study concludes that the experience of the economies reviewed confirms that investment liberalisation and the resulting increase in FDI inflows has brought important benefits.[82] These benefits have included increased output, incomes, employment and exports; significant transfers of advanced technology to the domestic economy; and advantageous "spill-over" effects, engendered by competition forces, onto the domestic economy. In a wider context, FDI has been a key instrument for integrating APEC economies into the global economy.

The literature reviewed also addresses outward foreign direct investment by domestic firms, for example, outward direct investment, and the implications of the outward flow of investment for the home country. Contrary to some public concerns that outward FDI has strong negative repercussions on the home country, it has been found that the home country's firms and labour can benefit from outward FDI. Foreign investment by domestic firms can create employment by raising exports of capital goods, and, in the long run, by influencing demand for domestically produced intermediate components, replacement parts, and associated goods and services.[83] Economic growth in the recipient country may also increase the demand for products from the FDI source country. Outward FDI, for example, has been identified as an important factor in the Japanese electronics sector success. The industry's success is partly due to a strategy of maintaining profitability of new product development by investing in ASEAN and China for outsourcing labour-intensive components.[84]

Trade and Policy Coherence

While liberalisation of trade and investment is an important component in improving living standards, it is only one component. A coherent set of policies is required to achieve a durable improvement in living standards.[85] This is an important conclusion as it stresses that an overall assessment of the costs and benefits of liberalisation are dependent upon choices made in other policy areas.[86]

Trade and FDI, as well as other international economic activities, are linked with a complex mix of "domestic" economic, and even social, policies.[87] How the opportunities of liberalisation are seized and benefited from, in large part, is dependent upon domestic policy decisions and how firms respond to these decisions. These policy links include the effect on trade of domestic policies that affect human resource development, economic infrastructure, environmental stewardship, adjustment to technology, and promotion of innovation.[88] Clearly, the intersection of international trade with traditionally domestic policy areas raises increasingly sensitive trade-off questions. This is particularly relevant and of broad public interest in respect to issues surrounding structural adjustment, such as labour market policies. Public interest is also high in regard to the linkages of liberalisation and the environment.

Trade liberalisation, by opening markets to increased competition and accentuating the on-going structural adjustment process, makes the costs and benefits of domestic policy choices more transparent. Poor policy choices, however, with or without trade, have a cost. Turner emphasised this point with respect to Europe by observing that Europe's unemployment problem is not due to a failure of competitiveness in the face of a global challenge, but due to a failure of economic flexibility in the face of developments most of which would have occurred even if trade and capital flows were no more global than in the 1960s.[89]

Low cost labour is but one of a number of factors influencing a firm's decision to undertake FDI.

The trade-domestic policy interface raises the question of policy coherence. Part of the coherence concept is to encourage countries to improve their capacity to respond to trade liberalisation opportunities.[90] This challenge requires that a distinction be made between governance as norm setting and rule making, as opposed to governance as results determining. Governments, through the negotiation of rights and obligations within the trading system, create trade opportunities. Such opportunities may or may not be seized by firms and individuals. The benefits of trade liberalisation are thus partly dependent upon decisions made outside of the formal trade governance apparatus of the trading system.[91]

This is also true for investment, where FDI is undertaken for a number of reasons. Investment is only one of a number of factors that firms consider in their strategic planning. Graham Vickery has set out the following five major objectives motivating FDI: 1) to facilitate the penetration of foreign markets; 2) to take advantage of the opportunities provided by technological change; 3) to secure a presence in all major centres of production and consumption; 4) to keep costs down; and 5) to increase global flexibility in production and distribution.[92] In deciding where to locate new investment, these motivating objectives, as well as a number of related factors such as the reliability of transportation and communications networks, political stability and social considerations, are taken into account by firms.[93] It is worth noting that access to low cost labour is but one of a number of factors influencing a firm's decision to undertake FDI in any particular location.

Trade and Adjustment

Trade and trade liberalisation by definition imply that the composition of production and employment changes in the countries involved. This, however, in no way implies that trade is the singular or most important factor contributing to pressure for labour force adjustment. Labour markets are in constant flux. At any given time, different sections of the economy are growing or contracting at different rates. Nor should it be understood that changes in the labour force or pressure for change, from whatever source, are an adverse economic development.

The economic benefits stemming from trade liberalisation require adjustment, including labour market adjustment. The OECD has summarised the empirical results of a number of studies conducted on the employment effects of trade liberalisation.[94] It concluded that the net impact of trade liberalisation on employment is in general small at the aggregate level of the overall economy. The labour adjustment required is also likely to be small with respect to changes occurring for other reasons, such as technological change or the emergence of new products. In an average year in developed countries, 20 percent of the work force will change jobs. The OECD report concluded that "the number of additional workers who would have to change jobs as a result of trade liberalization would be likely to be only a fraction of the normal rate of labour turnover, particularly if the trade liberalization were spread over a number of years."[95]

The employment effect is more important, however, at the sectoral level, although smaller employment changes occur due to other causes, such as technological developments. The OECD found that trade liberalisation and increased trade in goods, especially with developing countries, tends to intensify structural change in the OECD countries through a labour-saving effect that reduces demand for unskilled workers while stimulating demand for skilled workers. On a sectoral basis, employment in low-wage and low-technology industries in OECD countries is adversely affected by imports while high-wage and high-technology industries experience gains in employment.[96] The OECD also noted that social "problems may arise if the job displacements tend to concentrate on groups of the labour force who are disadvantaged anyway, eg, unskilled labour."[97] From a political perspective, highly visible and concentrated sectoral job losses may not offset the more diffused job gains.

The central conclusion of the OECD work – that the role of liberalisation in labour market performance is much smaller than many believe – has also been reached by others.[98] Thygesen, Kosai, and Lawrence conclude that in the US case the slow rise in average compensation since 1979 reflects slow domestic productivity growth in sectors that are not subject to international competition.[99] Further, growing wage inequality in the US results primarily from changes in production methods and technologies.[100] And finally, trade with developing countries in particular appears to have had a small impact on the wages of less-skilled workers.[101]

Trade liberalisation implies that short-term structural adjustment is necessary for longer-term prosperity. This creates challenges for other policy areas, and raises the question of how governments can most effectively intervene to facilitate adjustment by firms and individuals to new conditions. It also raises the question about whether those experiencing pressure to adjust from foreign sources should be treated any differently than those facing pressure from domestic sources.

Analysts have noted that the type of trade and the type of structural adjustment pressures that occur can influence the public's perception of whether or not trade is beneficial.[102] Trade amongst OECD countries can be characterised as intra-industry, such as, trade in similar products. In this case, the gains from trade are realised from increasing specialisation. Adjustment in this case involves shifting employment and other factors of production within a firm to new production lines, or shifts within an industry. There is no major deindustrialisation of a sector, and the foreign competitors are not often regarded by the public as low-cost competitors with major differences in factor endowments.

Inter-industry trade, the trade of different products from different industries in different countries, is often associated with OECD member country trade with developing countries. This type of trade can require that adjustment be made by an entire industry. The entire workforce of an industry could face change due to new low-cost producers. This type of industry adjustment, which is visible in the media, prompts demands from the industry and employees to remove the threat of foreign producers.

Trade is not the main cause of income inequality in OECD or non-OECD economies. Through liberalisation, low-skilled workers in developing countries can benefit because the demand for their labour increases. Thus, it has been observed that international trade does not necessarily worsen income inequality in a global context.[103] In developed countries, skill-biased technological change has increased relative demand for more skilled workers.[104] The appropriate policy response is to assist the adjustment of workers in a knowledge-based economy whatever the sources of change.

Increased competition means that unless firms match the productivity gains of their competitors, the wages of their workers will suffer. In the longer term, trade protection does not upgrade the skills of workers or contribute to a more flexible workforce. Overall, the literature suggests that the blame attributed to trade and investment liberalisation as the cause of social disintegration and instability in economies is often overstated. Moreover, even though adjustment is a "cost" in the short-run, it is a "benefit" in the longer-run. Lustig summarises this view:

> It may be important to note that even if trade protection may bring small, short-term relief for unskilled workers, this will be at the expense of lower growth and living standards – including those of less-skilled workers – in the future. A more fruitful alternative would be to pursue policies designed to upgrade the education and skills of the working population.[105]

Trade is not the main cause of income inequality in OECD or non-OECD economies.

Trade and the Environment

The public has expressed some anxiety with respect to potentially negative environmental effects of trade and trade liberalisation, particularly that through adverse effects on the environment, trade may lower the overall quality of life.[106] Addressing this concern in an objective manner may well be the key to maintaining public support for an open trading system and building support for a strengthened and more open multilateral trading system, including investment. Liberalisation and a high quality environment share the common objective of improving living standards. To achieve this objective, cooperation is required because of the interdependence of countries on both of these issues. While there is some literature available on the trade and environment interface, more analytical work is required to develop a more sound understanding of the relationship.[107]

Trade and environmental concerns interact in a number of ways. Some of these are direct, such as the import and export of environmentally friendly or hazardous products. Others are indirect, such as the influence of trade on living standards. Higher standards of living can have both positive and negative implications for the environment. Krueger and Grossman outlined three mechanisms on how trade and foreign investment policy can affect the level of pollution and the rate of resource depletion.[108] These mechanisms are the scale effect (where an increase in trade and investment liberalisation leads to an expansion of economic activity), the composition effect (where liberalisation leads to a change in the composition of products an economy produces) and the technique effect (where technological change is associated with trade and investment).

When assessing the impact of trade on the environment, environmental policy must also be considered.[109] Trade and investment are not necessarily adverse for the environment. When environmental policies are set at appropriate levels, available evidence suggests that trade and investment activities usually will have a positive impact on the environment. When environmental policies are *not* set at appropriate levels, trade and investment activities can aggravate environmental problems. A significant factor is the nature of the environmental policy itself.[110]

There appears to be broad agreement that certain types of subsidies may contribute to environmental degradation.[111] A World Bank report stated that: “Some government polices are downright harmful for the environment. Notable here are distorted prices in general and subsidised input prices in particular.”[112] A key message of the report was the importance of removing subsidies that encourage excessive use of fossil fuels, irrigation water, pesticides and logging. The Worldwatch Institute has documented how subsidies for such activities as mineral production, logging, fishing, agricultural inputs and production, and energy use have contributed to a range of environmental problems.[113]

If prices for products are distorted, such as through subsidies, trade and trade liberalisation may have an adverse environmental impact. This, however, does not imply that trade or trade liberalisation should be avoided, nor that trade measures are the most appropriate response to subsidisation of resource use.[114] Rather, an appropriate domestic environmental policy, crafted to internalise environmental costs, is required to avoid negative environmental impacts.[115] In particular, subsidies to producers or consumers of energy and agricultural products often contribute to trade distortions as well as having negative environmental implications. The reduction or elimination of these types of subsidies has both a beneficial effect on trade and the efficient use of resources as well as the environment.

The fear that differences in environmental standards will promote widespread FDI and the relocation of firms to economies with lower effective environmental standards, such as, "pollution havens", and result in a race to the bottom for environmental standards, does not have a sound empirical basis. The OECD has made observations in response to this fear.[116] First, there is little empirical evidence indicating that countries lower their environmental standards in order to attract so-called "dirty" industries. Second, there is not much evidence of firms relocating to countries with lower environmental standards in order to take advantage of the lower standards.

While firms do move from high to low standard countries, the reasons for doing so usually have little to do with environmental standards in either country. Very few firms undertake foreign investment with reduced environmental compliance costs as their primary objective. This said, the study notes that the threat of industrial relocation is often used by firms who would like to have the burden of environmental policies reduced. And that in effect, "the threat of industrial migration based on "pollution havens" (rather than the reality of this migration) may be generating a "political drag" on environmental policy-innovations in OECD countries."[117]

Moreover, trade and investment in environmentally-preferred products and services are important mechanisms through which liberalisation can benefit the environment. The key to this relationship is technology, and what products embodying the latest technologies and services providing technologies imply for the environment. International diffusion of technology and the use of efficient (resource-saving) products can be facilitated by freer trade and liberal investment policies. [118] FDI and technology transfer also imply that the links between trade and the environment need to be considered in a long-run framework.

The fear that differences in environmental standards will promote widespread FDI and the relocation of firms to economies with lower standards does not havea sound empirical basis.

Liberalisation, Governance, and National Sovereignty

Liberalisation, and rules setting out rights and obligations, has evoked fears on the part of a number of individuals and organisations that national policy autonomy, or even sovereignty, has been gradually undermined to the detriment of society.[119] The OECD describes this concern as "the perception that increased global competition, underpinned by global trade and investment agreements, is eroding the capacity of governments to exercise national 'regulatory' sovereignty; that is, to independently determine national policy objectives and implement regulatory decisions on both economic and social issues".[120] Yet constraints on independent action, with no regard to international repercussions, should not be considered as an inevitably negative development.

Constraints on governments may be positive as they add predicability to the conduct of international relations and allow for a world-wide trade regime to function.[121] In other words, the WTO is not a cost to be endured, rather it is a benefit to be actively supported.[122] For smaller economies which would otherwise be subjected to discriminatory trade policy actions from larger economies, this is particularly important. International commitments may also act as a counterweight to protectionist forces and short-term political opportunism.[123] To the extent that there is a dilution of unrestrained sovereignty, it can be offset through the use of influence by national governments in international organisations and the establishment of international rules. Globalisation, and the international governance that has accompanied it, should not be seen as the death of the nation state nor as the reckless throwing open of vulnerable domestic economies to chaotic forces.[124]

Trade liberalisation and trade governance is manifest in internationally negotiated rights and obligations.

Keohane has asked why international institutions, in a world dominated by sovereign states, exist if they are seen as opposed to, or above, the state? He asserts that, in fact, international institutions are viewed as devices to help states accomplish their domestic objectives.[125] In this sense, governments' participation in trade and investment liberalisation negotiations constitutes the exercise of their sovereignty rather than a surrender of it; and the negotiating process reflects the need for governments to move forward toward a set of rights and obligations in a manner that is consistent with their domestic political choices. The evolution of the multilateral trading system, from GATT to WTO, was brought about by a series of political choices made over almost fifty years. The argument that participation in multilateral agreements is actually an exercise of sovereignty is supported by many. Looking beyond liberalisation, Slaughter suggests that international organisations like the United Nations cannot function effectively independent of the major powers that compose it, nor will those nations cede their power and sovereignty to an international institution.[126]

Trade liberalisation and trade governance is manifest in internationally negotiated rights and obligations. Governance is about giving direction, but it is also about providing an analytical framework for issue formulation. In an international context, with the recognition that new policy tools and international cooperation will be required, Renato Ruggiero, the current Director-General of the WTO, has characterised this governance challenge as the risks and benefits of "Inventing the Future".[127]

Does trade liberalisation, or globalisation more generally, require a dismantling of national social welfare mechanisms and a race toward minimal government? The answer to this is not likely. The fear that governments are unable or have been unable, to implement regulatory decisions on social issues is not supported by the evidence. Krugman and Lawrence have emphasised that governments retain substantial autonomy in regulating their economies, designing their social policies, and maintaining institutions that differ from those of their trading partners.[128]

Rodrik believes that a key component of the implicit postwar social bargain in the industrial countries was the provision of social insurance and safety nets at home in exchange for the adoption of freer trade policies.[129] Rodrik further explains the historical context of the postwar period which witnessed two trends: the growth of trade and the growth of government. Prior to the Second World War, government expenditures averaged around 20 per cent of the GDP of today's industrialised countries. By the mid-1990's, that figure had more than doubled. Rodrik concludes that there is a surprisingly strong association across countries between the degree of exposure to international trade and the importance of the government in the economy.

In addition to the increasingly evident links with domestic policy areas, there is an intertemporal dimension that may influence individual views on the nation state and its linkage with liberalisation. Governments engage in "governance" activities that can be characterised as focusing on either the short-term or the long-term. Short-term activities are concerned with the "here and now" or the immediate, political costs and benefits. The long-term activities are focused on future costs and benefits, as well as how current costs may be required to enable or to increase future benefits. All governments place priorities, often undefined, on the relative importance of these time horizons. The intertemporal dimension is important when considering trade. It allows structural adjustment in response to new trade policies and trade patterns, which may be costly in social, economic, and political terms in the short-run (and therefore seen as threats to the nation state), to be seen in a broader perspective.[130]

With respect to FDI, fears that foreign investors will be less likely than domestic investors to identify with or accept/support the host government's public policy goals are unsubstantiated, as is the assertion that foreign investors are systematically poor corporate citizens. The assertion of a loss of economic sovereignty on the basis of the level of foreign ownership is also suspect as government policies can be applied irrespective of the ownership of the firm.

With liberalisation in the broad self-interest of economies, and not detrimental to the exercise of national sovereignty, why is it that countries maintain and at times strengthen restrictions? There appears to be two explanations. First, understanding trade and investment and the links with the domestic economy is not an easy or straight forward task. Consequently, the public may be misinformed and any misunderstanding is likely to translate into less political support for liberalisation than would otherwise be the case. Second, there is a political economy explanation for protectionism.[131]

This literature draws attention to the fact that some firms and individuals gain, sometimes quite considerably, from protected markets. Protection influences the distribution of income, with the income gains being concentrated in the few who actively support political regimes that are willing to allow the protection to continue or even increase. The losses are spread over a large section of the public, and on a per capita basis are often not large enough to stimulate collective and coordinated action to act as a political counterweight to those seeking protection.[132]

Conclusions

It is hoped that this short paper, summarising contemporary views on liberalisation, has contributed to developing a realistic view of trade and investment liberalisation. Liberalisation is not the root cause of the world's economic ills, nor is it the panacea. The literature highlights three key interrelated themes. First and foremost, on balance in the long-term, trade and FDI liberalisation is beneficial to society. Liberalisation promotes efficiency, encourages innovation, raises incomes, and gives consumers a greater choice of goods. Liberalisation is a means to an end, rather than an end in itself.

On balance in the long-term, trade and FDI liberalisation is beneficial to society.

A second major theme is that while liberalisation of trade and investment is an important component in improving living standards, it does not stand alone. Liberalisation is only a component. A coherent set of policies is required to achieve a durable improvement in living standards. This is important as it stresses that the cost and benefits of liberalisation are dependent upon choices made in other policy areas. This is particularly relevant with respect to issues surrounding structural adjustment such as labour market policies and sustainable development.

Third, short-term structural adjustment is necessary for longer-term prosperity. This creates challenges for other policy areas. Particularly, there is a need to facilitate adjustment, and for the gains from liberalisation to be as widely shared as possible. This requires policies to help, in particular, those most affected by adjustment.

The concerns over trade and investment liberalisation inducing social disintegration are not justified. Liberalisation is not the main cause of income inequality. Rather, skill-biased technological change has increased demand for more skilled workers and reduced that of unskilled labour. Moreover, in the longer term, trade protection does not upgrade the skills of workers or contribute to a more flexible workforce, and this has its own negative social consequences. The appropriate policy response is to facilitate the adjustment of workers in increasingly knowledge-based economies, whatever the sources of change.

Endnotes

1 The purpose of the "The Impact of Liberalisation: Communicating with APEC Communities" project, as agreed to by APEC Ministers, is to improve understanding of the impact of liberalisation at the community level in APEC economies.

2 It should be noted that the logic for international trade and for domestic trade are the same, such as, division of labour and specialisation. This logic may also be applied to individuals and trade among individuals. Without trade, each individual would have to be self-sufficient, and consequently would have an extremely low living standard and short life span.

3 This example is taken from Marc. T. Law and Fazil Mihlar, *Debunking the Myths: A Review of the Canada-US Free Trade Agreement and the North American Free Trade Agreement,* Public Policy Sources, no. 11, The Fraser Institute, (1998). This approach to understanding trade is taken from James Ingram, *International Economic Problems,* (New York: John Wiley, 1966).

4 Paul R. Krugman, "What Do Undergrads Need To Know About Trade?", *American Economic Review,* 83 (May 1993). From the highly charged public debate over the North American Free Trade Agreement, Gary Hufbauer has drawn similar conclusions:
"Honest public discourse requires an analysis of sectors that might be adversely affected by trade liberalization, accompanied by calculations of likely job losses.
Similar estimates should be made of sectors that will be favorably affected, with calculations of likely job gains.
The point that trade liberalization does not, on balance create or destroy jobs must be made again and again.
It should be emphasized that trade liberalization generally (but not always) shifts from employment from lower paid to higher paid jobs.
The point should also be made that freer trade invariably means lower cost and greater variety of goods and services for consumers."
See, Gary C. Hufbauer, "Surveying the Costs of Protection: A Partial Equilibrium Approach" ch. 2 in *The World Trading System: Challenges Ahead.* ed. Jeffrey Schott, (Washington: Institute for International Economics, 1996), 29.

5 Lower import prices in turn alters favourably the terms of trade. Thus ceteris paribus, welfare is increased. The terms of trade measure the number of units of imports a country can obtain for each unit of exports.

6 Economies of scale means that costs vary with the level of output. Learning by doing means that with experience in particular tasks, workers and managers become more efficient in carrying them out. Thus costs are reduced at all levels of output. Economies of scale and learning by doing may occur simultaneously. See Kenneth J. Arrow, "The Economic Implications of Learning by Doing", *Review of Economic Studies,* 29, (June 1962).

7 The term "new trade theory" refers to models of international trade that take into account economies of scale and product differentiation.

8 This may be thought of as an additional trade benefit from specialisation with variable costs that can be reduced.

9 US International Trade Commission, The Dynamic Effects of Trade Liberalization: An Empirical Analysis, Washington DC, 1997.

10 Leibenstein, H. "Allocative Efficiency vs. X-Efficiency", *American Economic Review,* 56, (June, 1966).

11 Michael G. Plummer, "ASEAN and the Theory of Regional Economic Integration: A Survey," ASEAN Economic Bulletin 14, no.2 (November 1997), 207.

12 The gains from trade depend on the pattern of comparative, not absolute, advantage. Even if country A can produce everything more efficiently than its trading partner (absolute advantage) it will still have an incentive to trade. This is because of the fact that country A can produce certain things more efficiently than others, leaving room for Country B to produce those products that it can produce relatively more efficiently. Thus both countries have a comparative advantage in producing some good. This theory of comparative advantage as the basis for trade was developed in David Ricardo, *The Principles of Political Economy and Taxation,* (London: J.M. Dent, 1817).

13 A potentially useful spin-off, when considering the dynamic effects of trade, is that specialisation allows for concentration of research and innovation in smaller number of areas.

14 An autarkic economy is a closed economy that does not trade internationally. There are no contemporary real world examples of a completely autarkic economy.

15 There are a large number of regional arrangements with specific characteristics/institutional mechanisms that may differ from the multilateral model discussed in this paper.

16 Tariffs come in two forms: ad valorem tariffs, which are expressed as a percentage of the price of the product, and specific tariffs, which is a fixed amount per unit of the product. Most tariffs are of the ad valorem type.
Aside from tariffs *per se* a related factor is the uncertainty inherent in unbound tariffs. Under the GATT, tariffs are limited only to the extent a country has made a specific "tariff binding", such as, a commitment not to exceed the ceiling rate in effect at which the tariff was bound. Tariff bindings reduce the risk of investing in activities related to

trade that is dependent on imported intermediate goods. Bindings also limit the upside of protection. Given the uncertainties associated with unbound tariffs, bindings may have an important liberalising effect, even when placed above current applied rates. See Joseph F. Francois, Bradley McDonald, and Hakan Nordstrom, "Assessing the Uruguay Round", a paper presented at The Uruguay Round and the Developing Economies, World Bank Conference, (Washington: The World Bank, 1995).

17 The General Agreement on Tariffs and Trade (GATT), opened for signature 30 October 1947. The GATT, containing tariff concessions and a set of rules preventing certain trade restrictions, was signed by 23 countries. On January 1, 1948, the Agreement was implemented. Since its establishment there have been eight Rounds of negotiations in the GATT. The seventh Round, which began in 1973, is referred to as the Tokyo Round, and the eighth Round, which lasted form 1986 to 1994, as the Uruguay Round. J.H. Jackson, *The World Trading System*, (Cambridge, Mass.: MIT Press, 1991) provides an insightful overview of the rights and obligations set out in the GATT.
The World Trade Organisation, which embodies the GATT, was established by the Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations. It was implemented January 1, 1995. The WTO currently has over 130 members. For a history of the Uruguay Round negotiations leading up to the establishment of the WTO, see John Croome, *Reshaping the World Trading System: A History of the Uruguay Round*, (Geneva: World Trade Organisation, 1995).

18 For details on specific countries' tariffs and other trade measures, see the Trade Policy Reviews published on a regular schedule by the WTO Secretariat.

19 These agreements, subsidies and government procurement, were also revised during subsequent negotiations.

20 For critiques on the WTO's Agreement on Government Procurement see Arie Reich, "The New GATT Agreement on Government Procurement: The Pitfalls of Plurilateralism and Strict Reciprocity", *Journal of World Trade*, 31, no. 2, (1997), and Jane Barrett and Robert T. Stranks, *Evolving Challenges for the WTO in Government Procurement*, Trade and Economic Policy Commentary no.23,(Ottawa: Department of Foreign Affairs and International Trade, August 1998).

21 Note that unlike a tariff, which raises the price of the foreign product and thus affects foreign supply, restrictive government procurement reduces the demand of the foreign product. In both cases, a trade distortion has been introduced.

22 W.C. Graham, "Government Procurement Policies: GATT, the EEC and the United States" in *Federalism and the Canadian Economic Union*, ed. M.J. Treblicock and others, (Toronto: University of Toronto Press, 1983).

23 Gary Clyde Hufbauer, and Joanna Shelton Erb, *Subsidies in International Trade*, (Washington: Institute for International Economics, 1984).

24 The constituent documents of the Agreement Establishing the World Trade Organisation are complex. For relatively comprehensive guides, but accessible to general readers, to the WTO see; Jeffrey S. Thomas and Michael A. Meyer, *The New Rules of Global Trade – A Guide to the World Trade Organization*, (Toronto: Carswell, 1997), and International Trade Centre UNCTAD/WTO and Commonwealth Secretariat, *Business Guide to the Uruguay Round*, (Geneva: ITC/CS, 1996).

25 The trade-related intellectual property agreement (TRIPS) does not liberalise trade *per se*. It provides intellectual property protection for products, and is defended on the grounds that intellectual property protection is needed to provide incentive for innovation and invention.

26 For a discussion of TRIMS, see; Centre on Transnational Corporations, New Issues in the *Uruguay Round of Multilateral Trade Negotiations*, (New York: United Nations, 1990), and Theodore Moran, *The Impact of Trade-Related Investment Measures on Trade and Development*, (New York: United Nations, 1991).

27 See Jagdish Bhagwati, *Protectionism*, (Cambridge, Mass.: MIT Press, 1990).

28 The issue of liberalisation of the financial sector is of particular interest in the midst of recent financial developments in Asia. A case can be made that greater market access of foreign banks might have helped to mitigate the crisis. Foreign banks entry increases competition in the sector, brings in new expertise, improves openness of the financial system. An article addressing the impact of financial sector liberalisation is "The Liberalization of Financial Sector in ASEAN", (Ministry of Finance, Thailand, 1996).

29 For the purpose of this paper, services are defined as: "economic activities that provide time, place and form utility while bringing about a change in, or for, the recipient of the service. Services are produced by (1) the producer acting for a recipient; (2) the recipient providing part of the labour; (3) the recipient and the producer creating the service in interaction". Dorothy I. Riddle, *Services-Led Growth: The Role of the Service Sector in World Development*, (New York: Praeger Publishers, 1986), 12.

30 It is worth noting that contrary to some public perception, jobs in the service industry are not inferior to jobs in manufacturing. De-industrialisation does not necessarily mean an economy is worse off. For example, see Joseph R.

Melsenheimer II, “The Services Industry in the ‘good’ verses ‘bad’ jobs debate”, *Monthly Labour Review*, (February 1998). This article focuses on the often controversial role of the service industry in the changing employment profile of the US. The main question addressed is: since manufacturing employment has declined as service employment has increased, how has this trend affected the quality of employment in the US. The main conclusion is that broadly labelling service jobs as lower quality and undesirable compared to manufacturing jobs is incorrect. There is a very diverse range of jobs in the service sector, from some of the lowest to the highest paying jobs in the economy.

31 The term “services” in this data refers to what the WTO refers to as “commercial services”. It includes “all services except government”.

32 WTO 1996 data are still provisional, such as, all trade figures are not compiled yet. However, data for most developed countries have been collected and reflected here.

33 Hoekman has noted that the analysis of barriers to service “requires an estimation of the tariff equivalent of a given set of measures and regulations pertaining to a service activity. Little work has been done in this connection”. Bernard Hoekman, “Assessing the General Agreement on Trade in Services,” *The Uruguay Round and the Developing Countries*, ed. Will Martin and L.Alan Winters, The World Bank (Cambridge, Mass.: Cambridge University Press, 1996), 92. For a detailed discussion on the shortcomings of services data see, Bernard Hoekman and Robert Stern, “Evolving Patterns of Trade and Investment in Services,” in *International Economic Transactions: Issues in Measurement and Empirical Research*, ed. Peter Hooper and J. David Richardson, (Chicago: University of Chicago Press, 1991).

34 The WTO Internet site, http://www.wto.org has a number of documents that explain the dispute settlement mechanism and the status of disputes, see “Settling Disputes – How Long to Settle a Dispute?”, “Settling Disputes – The Panel Process”, and “Overview of the State-of-Play of WTO Disputes”. Dispute settlement mechanisms are also found in other trade agreements, such as the North American Free Trade Agreement.

35 Current US Trade Representative Charlene Barshefsky recently highlighted competition law and restrictive business practices as barriers to trade. The USTR observed that with respect to Japan “markets remain largely closed, opaque and driven more by informal cliques than by laws, rules and contracts”. She also raised the issue of bribery and corruption and called for the WTO to “begin tackling head on bribery and corruption”. “Barshefsky Calls on WTO To Reduce Structural Barriers To Trade”, *Inside US Trade*, 16, no. 15, (April 17, 1998), 15.

36 The Committee on Trade and Environment is open to all Members of the WTO. It builds on progress achieved in GATT through the work of the GATT Group on Environmental Measures and International Trade – a Group the had been active since 1991.

37 World Trade Organisation, *Singapore Ministerial Declaration*, (Singapore: WTO, December 13, 1996), par.21.

38 A study by PECC identified the incidence of FDI impediments in the APEC economies. These impediments included taxation incentives, performance requirements, restricted investment sectors, and screening/notification procedures. Pacific Economic Cooperation Council (PECC), *Survey of Impediments to Trade and Investment in the APEC Region*, Singapore, 1995.

39 This section draws on material presented in a paper by Nipa Banerjee, *Recent Trends in Foreign Direct Investment: A Comparison of Canada with the USA and Mexico*, Trade and Economic Analysis Reference Document no.2, (Ottawa: Department of Foreign Affairs and International Trade, January 1998).

40 Julie K. Fujimura, *Global Strategies and Foreign Direct Investment: Implications for Trade and the Canadian Economy*, Policy Staff Paper No. 7, (Ottawa: Department of Foreign Affairs and International Trade, March 1994).

41 Rachel McCulloch, “New Perspectives on Foreign Direct Investment”, in *Foreign Direct Investment*, ed. K.A. Froot (Chicago: University of Chicago Press, 1993); B. Blonigen and R. Feenstra, *Protectionist Threat and Foreign Direct Investment*, NBER Working Paper no. 5475, (1996).

42 The possibility not only of increased intra-regional investment, but also of increased third country investment were powerful incentives for Canada to agree to the investment provisions of the FTA and NAFTA.

43 Alan M. Rugman, *Multinationals and Canada-United States Free Trade*, (Columbia: University of South Carolina, 1990).

44 Brian Hindley, Foreign Direct Investment: The Effects of Rules of Origin, Discussion paper No. 30, (London: Royal Institute of International Affairs, 1990); Alan M. Krueger, *Free Trade Agreements versus Customs Unions*, NBER Working paper No. 5080, (1995). Normally, members of free trade agreements maintain their own external tariff schedules. This creates the need for “rules of origin” to determine if inputs originating in a non-member country and imported into the free trade zone by a member country for further processing would receive free trade treatment when the final product is exported to another member country. Rules of origin can have a protectionist effect and lead a member investor to source inputs inside the free trade area. This would encourage non-member countries to invest within the free trade area. Similarly, the Hub and

Spoke system may influence investment choices, with investors preferring to invest in the "hub" than the "spoke". Robert Baldwin, *The Effect of Trade and Foreign Direct Investment on Employment and Relative Wages*, NBER Working Paper No. 5037, (1995); World Trade Organisation, *Regionalism and the World Trading System*, (Geneva: WTO, 1995).

45 UNCTAD, *World Investment Report 1997*, (New York: United Nations, 1997).; OECD, *The Impact of Foreign Investment on Economies of OECD Countries*, (Paris: OECD, 1993).; Rachel McCulloch, "New Perspectives on Foreign Direct Investment", in *Foreign Direct Investment*, ed. K.A. Froot (Chicago: University of Chicago Press, 1993).

46 Richard E. Caves, "Multinational Firms, Competition and Productivity in Host Country Markets", *Economica* 41, no. 162, (1974).

47 Hal Hill, "Foreign Direct Investment and East Asian Economic Development", *Asian Pacific Economic Literature*, 4, (1990).; R. Lipsey "Foreign Direct Investment in the United States and US Trade", *Annals of the American Academy of Political and Social Sciences*, 516, (July 1991).

48 Chen, Edward, ed., *Transnational Corporations and Technology Transfer to Developing Countries* (London; Routledge, 1994), vol. 18, *The UNCTC Library of Transnational Corporations: International Business and the Development of the World Economy*, ed. John Dunning.

49 Hal Hill, "Foreign Direct Investment and East Asian Economic Development", *Asian Pacific Economic Literature*, 4, (1990).; B. Aitken, G. Hansen and A. Harrison, *Spill-Overs, Foreign Investment and Export Behaviour*, NBER Working Paper No. 4967, (1994).

50 These types of restrictions would be inconsistent with the WTO TRIMS (Trade Related Investment Measures)obligations.

51 For instance, the deliberate policies of host governments to set up export promotion zones (for example, the Free Economic Zones in East Asia) to stimulate export, employment, and technology transfer have encouraged foreign firms to establish affiliate operations in these zones. Edward Graham and Paul Krugman, *Foreign Direct Investment in the US*, (Washington: Institute for International Economics, 1991).; Edward Graham and N. Anzai, "The Myth of a Defacto Asian Bloc: Japan's Foreign Direct Investment in East Asia", *The Columbia Journal of World Business*, 24, (1994).; P. Naujoks and K. Schmidt, *Foreign Direct Investment and Trade in Transition Countries: Tracing Links*, Kiel Institute of World Economics Working Paper No. 704, (1995).

52 World Trade Organisation, *Annual Report 1996: Trade and Foreign Direct Investment*, (Geneva: WTO, 1996).

53 Edward Graham and Paul Krugman, *Foreign Direct Investment in the US*, (Washington: Institute for International Economics, 1991); Edward Graham and N. Anzai, "The Myth of a Defacto Asian Bloc: Japan's Foreign Direct Investment in East Asia", *The Columbia Journal of World Business*, 24, (1994); P. Naujoks and K. Schmidt, *Foreign Direct Investment and Trade in Transition Countries: Tracing Links*, Kiel Institute of World Economics Working Paper No. 704, (1995).

54 Organisation for Economic Cooperation and Development, *The Impact of Foreign Investment on Economics of OECD Countries* (Paris: OECD, 1993).

55 R. Covari and Ronald Wisner, *Foreign Multinationals and Canada's International Competitiveness*, Investment Canada Working Paper no. 16, (June 1993).

56 These are Chapter 8 of the World Bank, *World Development Report 1995: Workers in an Integrating World*, (Washington, DC: The World Bank, 1995), and Chapter VI of the International Monetary Fund, *World Economic Outlook*, (Washington: IMF, May 1993).

57 The IMF document classifies developing countries into four categories according to the orientation of their trade strategy during the 1974-1992 period: (1) strongly outward-oriented;(2) moderately outward-oriented; (3) moderately inward-oriented; and (4) strongly inward-oriented.

58 Organisation for Economic Co-operation and Development, *Open Markets Matter: The Benefits of Trade and Investment Liberalization*, (Paris: OECD, 1998). Economic Committee of the Asia-Pacific Economic Cooperation, *The Impact of Trade Liberalization in APEC*, (Singapore: APEC, November 1997). Commonwealth of Australia, *Trade Liberalisation: Opportunities for Australia*, (Sydney: Department of Foreign Affairs and Trade, 1997).

59 The study uses computable general equilibrium (CGE) model simulations to assess the impact of APEC members' liberalisation and trade facilitation initiatives as set out in the Manila Action Plan (MAPA)for APEC, which was agreed to by APEC Ministers in November, 1996. The MAPA is a collective work by all APEC members, consisting of individual action plans, collective action plans and other joint activities with a view to reaching the Bogar Declaration goals.

60 The CGE model results are not forecasts. The results are informed estimates of the economic benefits of trade liberalization and trade facilitation. Moreover, the CGE only captures "modellable" measures such as tariff cuts and the reduction of border costs through changes in customs procedures. Two points must be kept in mind. First, scale economies and issues such as the importance of effective dispute settlement to firms production decisions, are not

incorporated into the model. Accordingly, the CGE estimates are indicative only and probably underestimate the full benefits of the impact of implementing MAPA. Second, the static benefits of trade are essentially the efficiency gains through reallocation of labour and capital. This requires adjustment and change. The expected CGE results may not be fully realised if the adjustment process does not work well. Deregulation and competition policies are therefore important to ensure that market mechanisms function well.

61 Other studies have also concluded that liberalisation will have a positive impact within the Asia-Pacific region. A literature review by Han and Cheong on the empirical findings of a number of studies concluded that the benefits of APEC trade liberalisation would be large both within and outside the APEC region, although the benefits would not be evenly distributed. Particularly, the benefits to economies with relatively higher levels of protection, China and the ASEAN countries, would be significant as these economies became increasingly integrated into the global economy. Second, the incorporation of trade facilitation and agricultural liberalization would bring forth sizeable benefits to the region, although agricultural liberalisation would require difficult adjustment in a number of APEC economies. Seungee Han and Inkyo Cheong, *APEC Trade Liberalisation: Its Implications,* OECD Economics Department Working Paper No. 197, (1988).

62 In monetary terms, the paper concludes that in the past decade, “the average Australian family has gained around $1,000 per year from tariff reductions.” For example, “Imported cars would cost around 25 percent more if the 1988 tariffs still applied – that’s an extra $5,000 on a $20,000 car. Clothing and footwear would cost around 14 per cent more – that’s an extra $300 or so per year for the average family to maintain its dress standards.” Commonwealth of Australia, *Trade Liberalisation: Opportunities for Australia,* (Sydney: Department of Foreign Affairs and Trade, 1997), 8.

63 A survey of studies conducted by the Institute for International Economics as well as by others on a number of countries is provided by Gary C. Hufbauer C. “Surveying the Costs of Protection: A Partial Equilibrium Approach”, ch. 2 in *The World Trading System: Challenges Ahead,* ed. Jeffrey Schott, (Washington: Institute for International Economics, 1996). Key studies addressed by Hufbauer are: Gary Clyde Hufbauer, Diane E. Berliner, and Kimberly Ann Elliott, *Trade Protection in the United States,* (Washington: Institute for International Economics, 1986); Gary Clyde Hufbauer, and Kimberly Ann Elliott, *Costs of Protection in the United States,* (Washington: Institute for International Economics, 1994); Nandoo Kim, *Measuring the Costs of Visible Protection in Korea,* (Washington: Institute for International Economics, 1996); and, Yoko Sazanami, Shujiro Urata, and Hiroki Kawai, *Measuring the Costs of Protection in Japan,* (Washington: Institute for International Economics, 1996).

64 Hoekman has produced rough estimates of service barriers. These indicate that barriers are high for certain services (transport, communications and finance). B. Hoekman, *Tentative First Steps: An Assessment of the Uruguay Round Agreement on Services,* Centre for Economic Research Discussion Paper No. 1150, (London: CEPR, 1995).

65 The OECD complied a significant body of evidence on the cost of protection in a 1985 study entitled *Costs and Benefits of Protection*.

66 Adam Smith was one of the first economists to discuss the benefits of international trade. Smith attacked the popular 1700s belief in mercantilism (that exports were good and imports were bad). Adam Smith, *Wealth of Nations,* (New York: Modern Library, 1994), 481.

67 Australian Pacific Economic Cooperation Committee, *Switching On – The Effects of Liberalisation in Asia’s Electronics Industry,* Studies in APEC Liberalisation, commissioned by the Australian Department of Foreign Affairs, (Canberra: Department of Foreign Affairs and International Trade, 1997).

68 The PECC study also raises the issue of liberalisation and policy coherence. The paper notes that “human resource development is critical for the transition into higher technology or more capital intensive processes, yet there may be constraints on training and the development of skills”. Consequently, the study concludes with the observation that: “The benefits of liberalisation are likely to be greater, achieved at lower cost and received sooner if these other impediments to the adjustment options of domestic producers are dealt with. As the experience of these four economies illustrates, these issues have become part of the continuing policy debate. Even so, the movement towards liberalisation of trade and investment in the electronics industry has not been held up in these four economies for the reason of these other challenges. Instead the commitment to liberalisation has led to a more intense focus on those new issues.” Australian Pacific Economic Cooperation Committee, *Switching On – The Effects of Liberalisation in Asia’s Electronics Industry,* Studies in APEC Liberalisation, commissioned by the Australian Department of Foreign Affairs, (Canberra: Department of Foreign Affairs and International Trade, 1997)16-17.

69 Australian Pacific Economic Cooperation Committee, *Pulling the Threads Together – The Effects of Liberalisation in Asia’s Textile and Clothing Industry,* Studies in APEC

Liberalisation, commissioned by the Australian Department of Foreign Affairs, (Canberra: Department of Foreign Affairs and International Trade, 1997).

70 See World Bank, *World Development Report 1995: Workers in an Integrating World, (Washington, DC: The World Bank,* 1995), and International Monetary Fund, *World Economic Outlook,* (Washington, DC: IMF, May 1993).

71 An important aspect of the global and regional patterns of production is foreign direct investment. In recent years, the growth of FDI has outpaced that of trade. From 1985 to 1996, the world stock of FDI increased form US $745 billion to US $3233 billion. An interesting and important feature of FDI is that most of the investment occurs within the developed economies. In 1967, the developed countries accounted for 69.4 per cent of the world stock of inward direct investment, and 70.2 per cent in 1996. The perception that most FDI, or even an increasing proportion, is flowing from the developed to the developing countries is incorrect. On a regional basis, however, the Asian developing economies have seen a remarkable increase in foreign inward investment during the 1980-1996 period, increasing from 9.5 per cent to 16.56 per cent of the global total. Source: UNCTAD, *World Investment Report; Transnational Corporations, Market Structure and Competition Policy 1997,* (New York and Geneva: UN, 1997).

72 The degree to which firms have become “stateless”, however, can easily be exaggerated. Much research and development is done in the home country, and consortia are often established among firms from the same region. Needless to say, there is a trend toward a greater level of cross-border business activities, but the “stateless” firm is more of a myth than a reality, at least to date. Keith Christie, *Globalization and Public Policy in Canada: In Search of a Paradigm,* Policy Staff Paper 93/01, (Ottawa: DFAIT, January 1993).

73 World Trade Organisation, *Annual Report 1996: Trade & Foreign Direct Investment,* (Geneva: WTO, 1996). Patrick A. Messerlin, *The Impacts of Trade & Capital Movements on Labour: Evidence on the French Case,* OECD Economic Studies No.1, (Paris: OECD, 1995). Rachel McCulloch, “New Perspectives on Foreign Direct Investment”, in *Foreign Direct Investment,* ed. Kenneth A. Froot (Chicago: University of Chicago Press, 1993). Donald C. MacCharles *Trade, Investment & Knowledge Flows in Relation to the Multinational Enterprises,* (Ottawa: Institute of Research on Public Policy, 1985). Pierre Mohnen, *The Relationship between R&D and Productivity Growth in Canada and Other Industrialized Countries,* (Ottawa: Economic Council of Canada, 1992). Robert Baldwin “The Effect of Trade and Foreign Direct Investment on Employment and Relative Wages”, *NBER Working Paper* No. 5037, February 1995. Daniel Schwanen, *Trading Up: The Impact of Increased Continental Integration on Trade, Investment and Jobs in Canada,* Commentary No.89, (Toronto, CD Howe Institute, 1997).

74 UNCTAD, *World Investment Reports,* (New York and Geneva: UN, 1993, 1994, 1995 and 1996).

75 World Trade Organisation, *Annual Report 1996: Trade and Foreign Direct Investment,* (Geneva: WTO, 1996).

76 Robert Lipsey, Magnus Blomstrom and Irving Kravis “R&D by Multinational Firms & Host Country Exports”, in *Science & Technology Policy: Lessons for Developing Asia,* ed. Robert Evenson and Ramis G. (Boulder: Westview Press, 1990). Pierre Messerlin, *The Impacts of Trade & Capital Movements on Labour: Evidence on the French Case,* OECD Economic Studies no.1, (Paris: OECD, 1995). World Trade Organisation, *Annual Report 1996: Trade and Foreign Direct Investment,* (Geneva: WTO, 1996).

77 B. Aitkin, G. Hanson, and A. Harrison, *Spill-Overs, Foreign Investment and Export Behavior,* NBER Working Paper No. 4967, (December 1994). Robert Lipsey, Magnus Blomstrom and Irving Kravis “R&D by Multinational Firms & Host Country Exports”, in *Science & Technology Policy: Lessons for Developing Asia,* ed. Richard Evenson and G. Ramis (Boulder: Westview Press, 1990). Edwin Mansfield and A. Romeo “Technology Transfer to Overseas Subsidiaries by US Based Firms”, *Quarterly Journal of Economics,* 95, (December 1980). R. Findley “Relative Backwardness, Foreign Direct Investment and the Transfer of Technology: A Simple Dynamic Model”, *Quarterly Journal of Economics,* 92, (February 1978).

78 Magnus Blomstrom “Foreign Investment and Productive Efficiency: The Case of Mexico”, *The Journal of Industrial Economics,* 35, (1986). Magnus Blomstrom, and Edward Wolff, *Multinational Corporations and Productivity Convergence in Mexico,* NBER Working Paper no. 1923, (1994). Richard Caves “Multinational Firms, Competition & Productivity in Host Country Markets,” Economica, 41, no. 162, (1974).

79 Magnus Blomstrom, Richard Lipsey, and M. Zejan, *What Explains Developing Country Growth,* in NBER Working Paper No. 4132, 1992.

80 Bernard Hoekman, “Assessing the General Agreement on Trade in Services,” in, *The Uruguay Round and the Developing Countries,* ed. Will Martin and L. Alan Winters, (Cambridge: The World Bank and Cambridge University Press, 1996).

81 Economic Committee – Asia Pacific Economic Cooperation, *The Impact of Investment Liberalization in APEC,* (Singapore: APEC, November 1997).

82 An earlier APEC Economic Committee study concluded that "the strong and growing trade and investment among the APEC member economies could encourage further specialisation, improve resource allocation and efficiency, and increase the flexibility, adaptability and dynamism of all APEC member economies. The Asian APEC member economies, however, will likely benefit the most from increased economic integration and the convergence process." Economic Committee – Asia Pacific Economic Cooperation, *Foreign Direct Investment and APEC Economic Integration*, (Singapore: APEC, June 1995)

83 Gary Clyde Hufbauer and Jeffrey Schott, *NAFTA: An Assessment*, (Washington, DC: Institute for International Economics, 1993), 19.

84 Sadao Nagaoka, "On Labour Market Consequences of Trade and Investment Liberalization", Presented at the OECD Workshop with Non-Member Economies on The Benefits of Trade and Investment Liberalisation, Paris, June, 1998.

85 This is a major theme in the OECD's *Open Markets Matter: The Benefits of Trade and Investment Liberalisation*, (Paris: OECD, 1998). The APEC Economic Committee has taken a step towards understanding multidisciplinary issues influencing standards of living. In September 1997, a symposium on APEC (and the world in general) and FEEEP (the Impact of Expanding Population and Economic Growth on Food, Energy, and the Environment) was held in Saskatoon, Canada. The symposium addressed these issues individually, and more importantly, the linkages between issues and the challenges such linkages hold for effective policy making. For a conceptual framework for integrated assessments see Robert T. Stranks and Ravish Mitra, *APEC and FEEEP: An Evolving Integrated Assessment*, Trade and Economic Policy Commentary no.19 (Ottawa: Department of Foreign Affairs and International Trade, November, 1997).

86 The relationship and interlinkages of trade and investment with other policy areas is a vast area of economic and non-economic literature. For example, links occur in such diverse areas as: Domestic Standards and Regulations, Economic Development Policies (including research and development), Agricultural Policy, Competition Policy, Intellectual Property Policy, Transportation and Communication Policies, Labour Policy, Environmental Policies, Taxation, Government Co-ordination Policies.

87 The nature of these links is not always clear or obvious. For example, bribery and corrupt business practices that distort competition and trade and investment is an issue. To this end, in an attempt to address corruption, in November 1997, the OECD members adopted the Convention on Combating Bribery of Foreign Public Officials in International Business Transactions. For an overview of the causes and consequences of corruption see Kimberly Ann Elliot, ed., *Corruption and the Global Economy*, (Washington, DC: Institute for International Economics, 1997).

88 While generally falling outside the scope of trade or investment liberalisation literature, it is important to note that trade and investment are influenced by exchange rates.

89 Adair Turner, "Globalization: Threat or Opportunity", speech delivered at the European Business School, March 25, 1998.

90 Indeed, the basis for trade, comparative advantage, may be considered in domestic policy terms. Comparative advantage is a dynamic, not a static concept. Industries that depend largely on human capital as opposed to a country's natural endowments may be located in any number of locations. Countries, through domestic policies such as education policy, can develop new areas of comparative advantage.

91 Elaborating on this point in respect to a number of APEC economies, an OECD study concluded: "Applying coherent and well co-ordinated macroeconomic and structural policies, and sustaining these policies over time, has proven to be the primary determinant of a successful trade liberalisation effort. In addition, lasting trade liberalisation in any country will depend on the trade policy stance of the major trading nations as well as on the effective functioning of the international system." OECD, *The Benefits of Free Trade: East Asia and Latin America*, Trade Policy Issues 3, 1994, p.7.

92 Graham Vickery, "Global Industries and National Policies", *OECD Observer* 179, (December 1992/January 1993).

93 The APEC investment study also reached similar conclusions and concluded that site selection is less a function of incentives offered to foreign investors than the economies offering them are inclined to hope. For investors, more fundamental factors are an attractive investment climate. These include the macroeconomic situation; a transparent legal, policy, and regulatory framework affecting FDI and other business matters; the economic infrastructure; and, in an increasing number of sectors, a well-educated labour force. See Economic Committee – Asia Pacific Economic Cooperation, *The Impact of Investment Liberalization in APEC*, (Singapore: APEC, November 1997).

94 OECD, *Trade and Employment*, C(89)42, (1989).

95 OECD, *Trade and Employment*, C(89)42, Annex Summary Report, (1989), 4.

96 OECD, *Symposium on Globalization of Industry: Government and Corporate Issues*, DSTI/IND(93)29/Rev2, (November 1993).

97 OECD, *Trade and Employment*, C(89)42, (1989), 29.

98 Lustig puts the concern and misperception of the role of

trade into stark policy terms; "identifying ways to address the rising economic polarization and declining living standards for the less-skilled in the United States deserves greater attention on the part of policy makers. Otherwise, many lawmakers are likely to continue focusing on the wrong instrument – that is, trade protection – to combat it." Nora C. Lustig, "NAFTA: Setting the Record Straight, *The World Economy*, 20, no.5 (August 1997), 606.

99 Niels Thygesen, Yutaka Kosai, and Robert Z. Lawrence, *Globalization and Trilateral Labor Markets: Evidence and Implications*, A Report to the Trilateral Commission, 49, (December, 1996). These conclusions are also found in Robert Z. Lawrence, *Single World, Divided Nations: International Trade and OECD Labor Markets*, (Washington, DC: Brookings Institution and OECD Development Centre, 1996).

100 John Bound and George Johnson, "Changes in the Structure of Wages in the 1980s: An Evaluation of Alternative Explanations," *American Economic Review* 82, (1992). G. Burtless, "International Trade and the Rise in Earnings Inequality," *Journal of Economic Literature*, (June 1995).

101 With respect to US, trade with developed and developing countries, similar results were found by Borjas, Freeman, and Katz who concluded that over the 1980-1988 period, trade explained little of the earnings differential between college-educated and high-school educated workers. George J. Borjas, Richard Freeman, and Lawrence F. Katz, *On the Labor Market Effects of Immigration and Trade*, Harvard Institute of Economic Research Discussion Paper 1556, (1991).

102 Niels Thygesen, Yutaka Kosai, and Robert Z. Lawrence, *Globalization and Trilateral Labor Markets: Evidence and Implications*, A Report to the Trilateral Commission, 49, (December, 1996).

103 Sadao Nagaoka, "On Labour Market Consequences of Trade and Investment Liberalization", Presented at the OECD Workshop with Non-Member Economies on The Benefits of Trade and Investment Liberalisation, (June 1998).

104 Nicholas Vanston, "How Trade Affects Job", *The OECD Observer*, No. 195, August/September 1995.

105 Nora C. Lustig, "NAFTA: Setting the Record Straight, *The World Economy*, 20, no.5, (August 1997), 610.

106 Trade-environmental concerns are both intra-generational and inter-generational. The latter reflects how today's problems will affect future generations. By-and-large the structural adjustment labour issues associated with liberalisation are intra-generational concerns.

107 See Kym Anderson and Richard Blackhurst, eds., *The Greening of World Trade Issues*, (Toronto: Harvester Wheatsheaf, 1992); Daniel C. Esty, *Greening the GATT: Trade, Environment and the Future*, (Washington, DC: Institute for International Economics, 1994); Jagdish Bhagwati and Robert. Hudec, eds., *Fair Trade and Harmonization: Prerequisites For Free Trade?*, 2 volumes, (Cambridge: MIT Press, 1996); OECD, *The Environmental Effects of Trade*, (Paris: OECD, 1994).

108 G.M. Grossman and A.B. Krueger, "Economic Growth and the Environment", *Quarterly Journal of Economics*, (1995).

109 Analytical work by the WTO has concluded "it is generally accepted that in order for these benefits to be realized, and for trade-induced growth to be sustainable, appropriate environmental policies determined at the national level need to be put in place." This arises as the most significant trade liberalization -environmental linkages pass indirectly through effects on levels and patterns of production and consumption. WTO Committee on Trade and Environment, *Environmental Benefits of Removing Trade Restrictions and Distortions*, Note by the Secretariat, WT/CTE/W/97, (November 1997).

110 See John Beghin and Michel Potier, "Effects of Trade Liberalisation on the Environment in the Manufacturing Sector," *The World Economy*, 20, no. 4, (July 1997), 437. They conclude that: "A major policy implication that emerges from the study is the need for coordination of environmental policies and trade liberalisation reforms. Although free trade can be beneficial to the environment in the case of formerly protected and inefficient (pollution-intensive) industries, it is difficult to determine *a priori* the environmental implication of the post-liberalisation division of labour in manufacturing activities. Economic theory alone cannot predict trade and production patterns in dirty activities in a world of many countries, commodities, and factors of production. Hence, the presence of environmental policies is instrumental in protecting the environment."

111 See the World Resources Institute's, *World Resources*, (annual publication) and UNCTAD, "Sustainable Development", TD/B/40(2)/6, (February 1994).

112 World Bank, *World Development Report*, (1992), 11. The report provides anecdotal evidence that indicates that many governments underprice natural resources.

113 David Malin Roodman, "Reforming Subsidies", in *State of the World 1997*, Lester R. Brown et al., (New York: W.W. Norton & Company, 1997).

114 For a discussion on some of the difficulties of using countervailing duties in response to "environmental subsidies" see Robert T. Stranks, *Pandora's Box?: Countervailing Duties and the Environment*, (Ottawa: Department of Foreign Affairs and International Trade, October, 1994).

115 The term "internalization of environmental costs" is found

in Principle 16 of the Rio Declaration adopted by the United Nations Conference on Environment and Development, ie. the Earth Summit, in 1992. There is an international consensus that the internalisation of costs is a positive development for the environment. Principle 16 reads:

> National authorities should endeavour to promote the internalisation of environmental costs and the use of economic instruments, taking into account that the polluter should, in principle, bear the cost of pollution, with due regard to the public interest and without distorting international trade and investment (UNCTAD, *The Effect of the Internalisation of External Costs on Sustainable Development*, TD/B/40 (2)/6, (7 February 1994), 26.

The internalisation of environmental costs may be thought of as "the attempt to get market prices to reflect the environmental costs of the production and use of a product in terms of natural resource utilisation, pollution, waste generation, consumption and other considerations." [OECD, "Concepts and Principles in International Environmental Law: Addendum 1, COM/ENV/TD(93)117/ADD1 (March, 1994), 4] Market imperfections, or market failures occur when "externalities" are not incorporated into market prices, and there is a gap between marginal social costs and marginal private costs. Government intervention in the form of environmental regulations, for example, attempts to internalise costs by placing the costs for pollution prevention and control on producers. Governments may also reduce the gap through taxation or charges.

The process of correction, therefore, may be thought of as "internalising the externality". This may obviously occur to varying degrees, and it is not a question of complete or no internalisation. In the case of policy that results in the underpricing of natural resources, increased production for domestic consumption or export may contribute to unsound environmental pressure on the natural resource or the associated use of the resource. A country's resource base, such as agricultural production, could be irreversibly reduced in the long-term. Should a country move toward internalising costs more fully, the producer's response would result in changes in production and trade patterns.

As set out in the text of the paper, this has some key policy implications. If natural resources are underpriced, trade and trade liberalisation may have an adverse environmental affect. This, however, does not imply trade is a negative or that trade liberalisation should be avoided. Rather, it implies that the appropriate environmental policy, the internalisation of environmental costs, is required to avoid negative environmental effects. Trade is not the fundamental cause of the environmental problems.

116 Organisation for Economic Cooperation and Development, *Economic Globalisation and the Environment*, (Paris: OECD, 1997).

117 Organisation for Economic Cooperation and Development, *Economic Globalisation and the Environment*, (Paris: OECD, 1997), 13.

118 John Beghin and Michel Potier, "Effects of Trade Liberalisation on the Environment in the Manufacturing Sector", *The World Economy*, 20, no.4, (July 1997), 437.

119 Two Canadian classics are Mel Hertig, *The Betrayal of Canada*, (Toronto: Stoddart, 1991), and Maude Barlow, *Parcel of Rogues: How Free Trade is Failing Canada*, (Toronto: Key Porter Books, 1990).

120 Organisation for Economic Cooperation and Development, *Open Markets Matter: The Benefits of Trade and Investment Liberalization*, (Paris; OECD, 1998), 76.

121 This is not specific to trade and investment liberalisation. An important aspect of sustainable development and protection of the global commons is the recognition of the need for joint and cooperative measures that may restrain national action.

122 It should also be recalled that the WTO is not a supranational organisation, and that it only administers what its Members have agreed to.

123 This benefit is sometimes called the "Ullyses effect" where international rights and obligations help prevent governments from being tempted to favour interest groups at the expense of the economy as a whole. Kym Anderson, "50 Years: Looking Back, Looking Forward", paper presented at The Graduate Institute of International Studies and World Trade Organisation, Geneva, 30 April, 1998.

124 Although there are international rules, this is not to say everyone welcomes them (or that the rules are adhered to at all times).

125 Robert O. Keohane, *International Institutions: Can Interdependence Work?*, Foreign Policy No. 110, (Spring, 1998). Keohane further argues that international institutions create the capability for states to cooperate in mutually beneficial ways by reducing the costs of making and enforcing agreements. Even powerful states have an interest in following the rules of well-established international institutions, since general conformity to rules makes the behaviour of other states more predictable. BIAC further notes that increasing economic interrelations and interdependence among our countries have led to unprecedented peace and prosperity in the world. Business and Industry Advisory Committee to the OECD (BIAC), *Addressing the Impact of Globalization: Promoting the Benefits of Change*, (Paris: BIAC, 1998).

126 Anne-Marie Slaughter, "The Real New World Order", *Foreign Affairs*, 76, no.5, (Sept./Oct. 1997).

127 Renato Ruggiero, "Charting the Trade Routes of the Future: Towards a Borderless Economy", speech given at the International Industrial Conference, San Francisco, 29 September, 1997.

128 Paul Krugman and Robert Lawrence, "Trade, Jobs, and Wages", *The World Economy* 21, no.4, (April 1994).

129 Dani Rodrik, *Has Globalization Gone Too Far?* (Washington, DC.: Institute for International Economics, 1997).

130 An additional consideration for the governance of trade is that countries do not share the same short-term and long-term priorities.

131 Kym Anderson, "Lobbying Incentives and the Pattern of Protection in Rich and Poor Countries", *Economic Development and Cultural Change,* 43, no. 2, (January, 1995). Gene Grossman and Elhanan Helpman, "Protection for Sale", *American Economic Review,* 84, no. 4, (September 1994). Arye L. Hillman, *The Political Economy of Protection*, (New York: Harwood Academic, 1989).

132 With regard to the domestic participation in foreign policy making, Milner argues that it is the character/diversity of the state that matters for both the definition and execution of international economic policy. Social groups such as labour organisations, capitalists, multinational corporations, and import-competing firms have identifiable preferences about national and international economic policy. Those domestic groups who directly benefit from international economic exposure or have strong international ties already will favour international openness and stability and press their governments to enact policies that promote such market characteristics. The more such groups exist domestically, the greater will be the pressure on policy makers to orient their policies in this direction. Helen V. Milner, "International Political Economy: Beyond Hegemonic Stability". *Foreign Policy*, no.110, (Spring, 1998).
Anderson has observed that the pattern of protection in an economy at a point in time may well be an equilibrium outcome in a national political market for policy intervention. Consequently, a new opportunity for liberalisation, such as through multilateral trade negotiations, can stimulate liberalisation by altering the incentives to participate in lobbying activities, and through such action, alter the equilibrium outcome and the pattern of protection. Kym Anderson, "50 Years: Looking Back, Looking Forward", paper presented at The Graduate Institute of International Studies and World Trade Organisation, Geneva, 30 April, 1998. Elaborations of this view can be found in Kym Anderson (ed.), *Strengthening the Global Trading System: From GATT to WTO,* (Adelaide: Centre for International Economic Studies, 1996); Gene Grossman and Elhanan Helpman, "Trade Wars and Trade Talks", *Journal of Political Economy* 103, no.4, (August, 1995); and, Bernard Hoekman and Michel M. Kostecki, *The Political Economy of the World Trading System: From GATT to WTO,* (London and New York: Oxford University Press, 1995).