The Development Drive Of North-South Versus South-South Ptas

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THE DEVELOPMENT DRIVE OF
NORTH-SOUTH VERSUS SOUTH-SOUTH PTAs

A Thesis
Presented to
The Faculty of Social Sciences
University of Denver

In Partial Fulfillment
of the Requirements for the Degree
Master of Arts

by
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November 2008
Advisor: Dr. Peter Sai-wing Ho
ABSTRACT

The importance of PTAs in today’s global economic order is unmistakable, especially during the last fifteen years when their proliferation has dramatically accelerated and their scope and structure have radically changed. However, the available theoretical framework (international trade theories) from which their developmental impact is assessed seems to be largely lagging behind. Hence, there is a crucial need for more realistic assessments of their embedded developmental features because an increasing number of developing countries are perceiving these agreements as one of the key instruments to propel their long delayed economic development. In this thesis, I strive to construct an alternative theoretical framework that can better adapt to current PTAs’ structures, allowing a more realistic assessment of their economic impact on developing countries. By following this alternative approach, I comparatively assess the development drive of two of today’s most important PTAs, namely NAFTA and ASEAN. The main conclusion echoes an increasing literature that warns developing countries from engaging in “reciprocal” North-South PTAs, but at the same time, encourages them to pursue South-South integration, which can prove to be beneficial for their development.
Simply...to my wife Sara without whom I could not have done it!
<table>
<thead>
<tr>
<th>TABLE OF CONTENTS</th>
</tr>
</thead>
<tbody>
<tr>
<td>CHAPTER I: INTRODUCTION .................................................................1</td>
</tr>
<tr>
<td>CHAPTER II: PRESENTING THE THEORIES .............................................10</td>
</tr>
<tr>
<td>2.1. The Traditional Theoretical Framework for PTA Analysis ...........10</td>
</tr>
<tr>
<td>2.1.1. Traditional Trade Theories (TTT) ..............................................11</td>
</tr>
<tr>
<td>2.1.2. Economic Development and TTT .................................................15</td>
</tr>
<tr>
<td>2.1.3. The Application of TTT to PTA Assessments ..............................19</td>
</tr>
<tr>
<td>2.2. Constructing an Alternative Approach to PTA Analysis ...............21</td>
</tr>
<tr>
<td>2.2.1. Delivery-Vehicles: Market Access and Foreign Investment ..........23</td>
</tr>
<tr>
<td>2.2.2. “Potential Dynamic” Gains from PTAs .......................................28</td>
</tr>
<tr>
<td>2.2.3. From Theory to Practice .........................................................34</td>
</tr>
<tr>
<td>CHAPTER III: MARKET ACCESS ISSUES IN NAFTA AND AFTA ............41</td>
</tr>
<tr>
<td>3.1. Pre-Existent Circumstances .......................................................43</td>
</tr>
<tr>
<td>3.2. The Texts Governing Market Access ............................................49</td>
</tr>
<tr>
<td>3.2.1. Liberalization Schedules .........................................................50</td>
</tr>
<tr>
<td>3.2.2. Rules of Origin .......................................................................53</td>
</tr>
<tr>
<td>3.2.3. Other Features ........................................................................55</td>
</tr>
<tr>
<td>3.3. Actual Market Access Outcomes ................................................58</td>
</tr>
<tr>
<td>3.3.1. Market Access in Manufactures ...............................................59</td>
</tr>
<tr>
<td>3.3.2. Market Access in Agriculture ..................................................64</td>
</tr>
<tr>
<td>3.3.3. Market Access in Services .......................................................66</td>
</tr>
<tr>
<td>CHAPTER IV: FOREIGN INVESTMENT IN NAFTA AND ASEAN ........72</td>
</tr>
<tr>
<td>4.1. Common Characteristics of IIAs ..................................................74</td>
</tr>
<tr>
<td>4.2. Foreign Investment Evolvements ................................................82</td>
</tr>
<tr>
<td>4.2.1. How and How Much Foreign Investment was Attracted? ............84</td>
</tr>
<tr>
<td>4.2.2. What Type of Investments and Where Did They go? .................88</td>
</tr>
<tr>
<td>CHAPTER V: A BRIEF DEVELOPMENT REVIEW ...............................98</td>
</tr>
<tr>
<td>5.1. Mexico’s Economic Development Evolution ................................99</td>
</tr>
<tr>
<td>5.2. ASEAN-10’s Economic Development Evolution ...........................106</td>
</tr>
<tr>
<td>CONCLUDING REMARKS .....................................................................116</td>
</tr>
<tr>
<td>REFERENCES ....................................................................................120</td>
</tr>
</tbody>
</table>
CHAPTER I: INTRODUCTION

The importance of Preferential Trade Agreements (PTAs)\(^1\) in today’s world trade patterns is unmistakable. About half of total global trade is now taking place within actual or prospective PTAs. In the case of the Western Hemisphere, for example, by the year 2004 some 86% of total trade will be free of duty as the result of the implementation of those PTAs already in effect. This does not take into account the future impact of the new agreements currently under negotiation (Majluf, 2004). Although PTAs have been an important part of the international economic maneuvering of many countries for quite some time, after the ‘90s, their proliferation has dramatically accelerated (see figure I.1), and their structures radically changed to include more trade and “non-trade” related aspects and to increase the number of members involved.\(^2\)

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\(^1\) According to Bela Balassa (1961), PTAs are the weakest and initial form of economic integration succeeded by Free Trade Areas, Custom Unions, Common Markets, and Economic Unions. Trade literature refers to PTAs in other ways such as, Regional Trade Agreements (RTAs) and Free Trade Agreements (FTAs). For simplicity and coherence, all throughout this thesis, I will refer to them as PTAs. Distinction will be made when necessary. See Panagariya (1998) for further discussion.

\(^2\) See Crawford and Fiorentino (2005) for a more detailed discussion on PTAs’ current trends.
The initial formation of PTAs, as we know them today, was led by Western Europe and dates back to the formation of the European Coal and Steel Community (ECSC) in 1951, which was later enlarged and complemented to become what we know today as the European Union (EU). European success was immediately associated with the idea that economic regional integration was strongly correlated with economic growth and prosperity, but little attention was paid to how such success was accomplished.

Eventually, during the ‘60s, dozens of trade schemes, trying to mirror the European experience, emerged in Africa and Latin America. These alliances covered all five levels of integration set out by Bela Balassa (1961). But unlike the EEC in Europe that flourished tremendously and expanded through the years, the replicas in Africa and Latin America either missed their deadlines rapidly, collapsed completely (or almost completely), or simply stagnated (Langhammer, 1992).

This initial wave of PTAs in Africa and Latin America has been recorded in economic history as “Closed/Old Regionalism”, and “Shallow Integration” has been recognized as its main cause for failure, which included problems that follow: i) Import-Substitution-Industrialization that only created inward-looking and protectionist policies, which lead to trade diversion; ii) the arrangements only involved developing countries (DCs) that lack strong economic foundations, capital, and an industrial base to sustain trade among themselves; iii) individual countries never fully committed to the integration process quickly dissolving the driving mode of the accords; and iv) all the schemes did

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3 Note that some form of preferential trade (North-South) took place during the colonial period between colonizers and their colonies; however, discussing this system is out of the scope of this research. For further discussion on this topic see Mitchener and Weidenmier (2008).

4 PTAs, Free Trade Areas, Custom Unions, Common Markets, and Economic Unions.
not have any credible enforcement mechanism of the rules initially implemented, enabling the commitment to vanish with time (Langhammer, 1992).

This disappointing experience of PTAs among DCs put off some of the initial momentum of regional integration, leaving the practice mainly restricted to Europe. However, as UNCTAD (2007b) explains, following the failure of international financial institutions to manage the financial shocks towards the end of the ‘90s, and given the slow progress of multilateral trade negotiations, regionalism was reborn, generating an even stronger second proliferation wave and assuming a more than ever prominent place in the international development agenda.

Unlike the initial closed/old regionalism that mainly focused on the reduction of trade barriers among members (shallow-integration), this “New Regionalism” – as it is often referred to in literature – arrived with a whole new philosophy, embracing the concept of ”Deep Integration”. Deep integration has emerged as the underlying principle of most of the current PTAs, prompting DCs to steer economic policies towards integration into global markets and to harmonize their economic institutions, laws, and regulations around a narrow but universal set of benchmarks of strong property rights, open markets, and good governance. Regardless of the “readiness” of the internal economic environment of each country, the following of this path has been presented as the best (and on some counts the only) way to ensure that the incentives and resources generated by global markets will support and sustain growth and development at the local level (UNCTAD, 2007b).

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5 Some authors such as, Pomfret (2005) and Majluf (2004) have identified a third wave of regionalism, starting during the last part of the ‘90s, which is characterized by its supra-regional scope. For the purpose of this research, since the PTAs included here fall under the second wave of proliferation, this third wave will not be discussed. For further details see the above authors.
Based on this rationale, new regionalism PTAs are taking a multi-tracked approach to economic integration, expanding the trade areas and sectors dealt with in the accord, as well as including many other non-trade related issues. They go from a straightforward trade agreement on goods and services to broader agreements as part of a general economic partnership. They involve issues such as investment, government procurement, environmental standards, labor standards, competition policy, and intellectual property rights (IPR) that were never addressed before in “trade” talks.

There are different interpretations regarding the general driving force behind this process, but as far as DCs are concerned, the overarching motive is the search for effective policy instruments to achieve sustainable development through the insertion of national economies into the globalization process. Also, a certain “domino effect” has been playing an important role in propelling this trend, with countries increasingly engaging in new PTAs as a means of counteracting perceived negative effects of discrimination and marginalization as other countries form PTAs (Majluf, 2004). In a way, as UNCTAD (2007b) explains, new regionalism reflects the tendency to perceive globalization as a process whereby access to markets of the North and attracting foreign investment is key to successful integration of DCs into the world economy.

Indeed, North-South PTAs (N-S PTAs) are the novel contribution of this new era of economic integration, arguing that DCs can greatly benefit from partnering with northern countries. But this new regionalism not only promises economic prosperity under N-S PTAs, it also ventures into assuring that, to a certain extent, some South-South

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6 See for example, Sampson and Woolcock, 2003; and Okamoto, 2003 (in Majluf, 2004).

7 The “Domino Effect” concept is largely attributed to Richard Baldwin (see Baldwin, 1993a).
PTAs (S-S PTAs) might enhance economic development if deep integration is embraced, unlike S-S PTAs from the ‘60s that only embraced shallow integration. Thus, these popular development promises of new PTAs have enticed many DCs to seek closer integration (even if only partially) and propel their economic development by partnering with both northern and southern countries. In fact, this tendency is clearly reflected by their active participation in about 50% of current PTAs (figure I.2).

Figure I.2. PTAs by Type of Partner.

![Figure I.2](image)

Source: Crawford and Fiorentino (2005).

Nonetheless, despite the energetic involvement of DCs in these new PTAs, there are still many “questions” about the goods and harms that they can bring to the development process, since they tend to largely deviate from any theoretical predictions. However, it is essential to note that most of the analysis on PTAs today is based on a theoretical framework that is greatly behind their current structural evolution, thereby falling far short from capturing and interpreting their actual outcomes. This is mainly because, historically, trade has been the primary focus of PTAs (i.e. old regionalism) and also of their study. Consequently, current PTA analysis is mostly derived from traditional trade theories and orthodox static economic analysis, which delimits any assessment to the welfare-trade-effects that can result from a certain PTA.

But as mentioned before, current PTAs go far beyond trade matters, making the current theoretical framework only inadequately explain their actual complex structures.
As UNCTAD (2007b) points out, this shortsighted analysis downplays or ignores altogether many other fundamental forces behind the integration processes taking place in most PTAs today, in favor of a singular fixation with the static welfare gains attached to a maximal level of openness and improved allocation efficiency.

Hence, adequate research that can provide reliable assessments on a PTA’s various effects is urgently needed, for it might be precisely their “ambiguous-nature” that tempts DCs to invest considerably large economic, political, and institutional resources, following a “just-in-case-approach” and hoping to foster economic development (Majluf, 2004). This is critical not only because these new PTAs might divert important and scarce resources from other development strategies, but also because they might have a negative impact, if they are not strategically embraced, by reducing the policy space (potential PTA costs) available to DCs.

Therefore, this thesis seeks to investigate into what other factors and circumstances are concerned with and/or altered by the current design of PTAs and how they ultimately influence economic development. This requires taking a more dynamic consideration of trade effects beyond welfare gains. But most importantly, this implies shifting from an exclusive focus on trade to incorporating into the analysis other aspects of the current economic integration wave, like international capital flows and their potential dynamic (positive or negative) effects on development. This digression from conventional thinking allows me to construct an alternative theoretical framework from which one can more “realistically” capture the actual development drive of current PTAs.

In constructing this alternative approach, particular attention is dedicated to the analysis of the impact on development of some aspects included in many PTAs today as
part of the deep integration process, like government procurement liberalization and IPR protection, which are not considered in conventional assessments. However, some other areas, such as labor and environmental standards, labor migration, and competition policy are largely omitted from the discussions here. This is not because they are less important, but because I have decided to keep the research more concise, and these aspects are less related to the direction and arguments outlined in this thesis. Short reference will be presented when necessary.

Moreover, my analysis shall be further reinforced by strongly considering the overall legal and practical aspects of “negotiating” a PTA, such as, bargaining power and general structural asymmetries among future members, which will likely influence the final developmental outcome for the DC involved. I emphasize these issues because one of my arguments is that it is not so important whether, in theory, PTAs are beneficial or not. What largely determines their development drive is the outcome of the negotiations.

This alternative framework will then be applied to the assessment of two different types of new regionalism PTAs, namely N-S and S-S. I have decided to utilize two different types as opposed to only one, not only in order to render the study more compelling and in line with my arguments, but mainly because conventional assessments, mostly based on static trade models, have already drawn strong judgments on the developmental features of each type, and have concluded that N-S PTAs are relatively more beneficial for development than S-S PTAs.\(^8\)

Thus, the overall scope of this thesis is to make two related contributions. First, I strive to highlight some of the limitations and inadequacies of traditional PTA analysis in

\(^8\) See for example, Schiff and Winters (2003); Mayda and Steinberg (2006); and Lo Turco (2003).
assessing the complex integration processes embedded in today’s PTAs. Second, by assessing two different types of current PTAs, I expect to collect some evidence to render my thesis compatible with my presumptions. In fact, I will show that by considering several other factors and circumstances involved in the formation of a certain PTA, oftentimes, the potentially positive welfare effects can be offset, causing the likely reversal of the final result on development of that PTA for the DC.

The main conclusion of this research echoes increasing literature⁹ that slowly but surely moves away from conventional assessments and into considering the many other dynamics of current PTAs. The general message emerging from this literature is the following: although economic integration (even if confined to few countries) can be a positive force for economic development, it is not enough to guarantee it. More specifically, it is suggested that DCs should proceed carefully with regards to “reciprocal” N-S PTAs given the large various asymmetries among members. In contrast, S-S PTAs, although they present the risk of minimal development benefits due to the development level of all members, are still relatively more development-friendly, simply because of the more leveled playing field, which increases the possibility of a fairer distribution of the benefits.

The North America Free Trade Agreement (NAFTA), signed in 1994 by Canada, the United States (US), and Mexico, was selected as the pioneer of its kind to represent the N-S PTAs. An assessment of NAFTA’s features and its effects on Mexico as the developing country is of particular relevance, as it has often been considered a model on which to base other N-S PTAs (UNCTAD, 2007b).

⁹ See for example, UNCTAD (2005 and 2007b); Hoekman (2005); and Khor (2007); and Kreinin and Plummer (2003) to mentioned just a few.
S-S PTAs are to be represented by the Association of South-East Asia Nations (ASEAN), which is one of the most integrated S-S PTAs today. ASEAN was founded in 1967 as a political regional alliance that mostly ignored substantial economic integration for the first 25 years. However, after 1992, with the formation of a series of trade and investment schemes, such as the ASEAN Free Trade Area (AFTA), the ASEAN Investment Area (AIA), and ASEAN Industrial Cooperation Scheme (AICO), the ASEAN economies decided to join the current regional integration trend. Although ASEAN as a whole will serve as the umbrella agreement, the other complementary schemes will be largely the subject of discussion in this research. ASEAN currently includes ten members: Singapore, Malaysia, Indonesia, Thailand, Cambodia, Vietnam, the Philippines, Brunei, Lao PDR, and Myanmar.\textsuperscript{10}

The rest of the paper is structured as follows: Chapter II thoroughly reviews the traditional theories behind PTA analysis, highlighting some of their limitations and presenting an alternative theoretical framework from which to draw eventual conclusions. Chapter III applies this approach to several trade-related/market access issues in NAFTA and AFTA assessing the respective accords’ impact on the development efforts of Mexico and of the ASEAN economies. Chapter IV applies the same approach and analyzes the impact that NAFTA investment provisions have had on Mexico’s development prospects as well as the ASEAN investment schemes on the ASEAN members. Finally, Chapter V thoroughly summarizes the actual development results that Mexico and the ASEAN economies have experienced during their respective PTA era.

\textsuperscript{10} More information on NAFTA and on ASEAN and its different trade and investment schemes is provided later throughout the corpus of the paper.
CHAPTER II: PRESENTING THE THEORIES

Mainstream economic theory suggests that “poorer” countries could benefit from closer integration into the global economy.11 Indeed, as discussed in Chapter I, it seems that many DCs today are “partially” following this suggestion by forming PTAs. However, as previously mentioned, there are many uncertainties about the goods and harms that PTAs can potentially bring to DCs. These uncertainties, I argue in this thesis, are largely derived from the inadequate and limited theories that analyze their effects. Hence, in this chapter, it is essential to briefly present the ABCs of these theories in order to identify where their inadequacies and limitations are born. This should allow me to build an alternative theoretical framework that can better adapt to the complex structures of current PTAs and facilitate a more realistic assessment of their development drive.

2.1. The Traditional Theoretical Framework for PTA Analysis

Traditionally, as their name implies, PTAs have been primarily concerned with trade, and so, trade has been the focus of their study. Thus, international trade theory has functioned as the theoretical backbone for their analysis. In order to support my claim about the limitations of current PTA analysis, I need to briefly present the foundations of traditional trade theory so as to illustrate how it perceives trade interaction among countries as a welfare improving mechanism and a potential development strategy.

11 See for example, World Bank (2005). Note, however, that these suggestions are mostly based on mainstream trade theory, which lacks substantial empirical support (see Deraniyagala and Fine, 2001).
2.1.1. Traditional Trade Theories (TTT)

The origins of traditional trade theories (TTT) can be traced back to the important contributions of two famous British economists, Adam Smith (1776) and David Ricardo (1817). Adam Smith strongly influenced current trade theories with his well-known concepts of the Invisible-Hand, the Self-Interest Behavior, and the Absolute Advantage. Basically, Adam Smith argued that if every individual and/or nation-state alike, pursuing their own interest, focused on doing what they are best at, economic activity would lead to maximization of resources, advancement of public welfare, and equality. David Ricardo, the soul founder of TTT, consolidated the benefits of international trade with his theory of Comparative Advantage. Unlike Smith, Ricardo mainly showed that it was not necessary to enjoy an absolute advantage for two nations to mutually benefit from trade. Instead, it was only necessary to enjoy a comparative advantage in the production of a certain commodity over the trading partner for both to obtain substantial welfare gains.

The basic idea behind these economist’s principles was simple: two nations will voluntarily engage in trade if, and only if, they both benefit from doing so; hence, any obstacles – managed trade or government interventions – that prohibits, restricts, or tax their trade will only diminish the potential welfare improving gains. This presented the first moves away from a mercantilist approach to trade which view trade as a win-lose situation instead of a win-win opportunity.

Largely, these principles have represented, to this day, the underlying foundations of TTT and the perception of international trade as a welfare improving practice. There are two central arguments upon which most current trade models are based in one way or another. These arguments present two slightly different approaches for the basis of trade,
but basically lead to the same outcome – increased welfare resulting from the passage from one “steady state” to a better one by efficiently reshuffling the available resources in the economy, increasing productivity, welfare, and living standards (see figure II.1).

The first one is the classical argument and structures its basis for trade as follows: two countries possess their own respective scarce amount of resources to allocate among different production utilizations, generating a certain Production-Possibility-Frontier (PPF). The respective resources are assumed to be given, and so are the countries’ consumption patterns. Labor is the only factor of production and is completely mobile between alternative uses within each country, but not between the two countries. The prices of commodities are solely based on their relative labor cost, which is the same among alternative uses within a country. The only difference, which ultimately creates the incentive for trade in the classical model, is the production processes (technology) that differ between the two countries, although, this technology is fixed for each country and non-transferable between them.

Secondly, during the early 1900s, with the arrival of neoclassical economics, new advancements were presented to the classical argument, trying to further reinforce the idea that countries could be better off with trade than in autarky. One particular model stands out: the Heckscher-Ohlin (H-O) model which presented a different argument for the basis for trade, but carried on the classical set up in many respects. Essentially, this model argues that countries possess relatively different factor endowments (capital and labor) for the production of goods and services, which ultimately determines a country’s comparative advantage. Countries have a comparative advantage in those goods for which the required factors of production are relatively abundant locally. This is because,
in this model, the prices of goods and services are ultimately determined by the prices of their inputs (rent and wages). Goods and services that require inputs that are locally abundant will be cheaper to produce and export than those goods and services that require inputs that are locally scarce. The basis for trade in the H-O model are exclusively based on factors endowment differences that yield different prices, since, unlike the classical model, technologies are assumed to be identical between the two countries.\footnote{Jayme (2001, p. 10) remains us, however, that “there is an extensive discussion in international trade literature about the validity of the H-O model. The most known limitation of this is the Leontief Paradox. Leontief (1953) found that the US (a capital-abundant country) exported labor-intensive commodities and imported capital-intensive ones, which reverts the H-O arguments”. Nonetheless, the factor endowment rationale is still strongly evoked today to select future trading partners among countries, especially for N-S PTAs where there are larger factor endowments differences between future members. A N-S PTA could result mutually beneficial because member countries could more efficiently exploit their respective relative abundant-factors of production.}

Practically, if the classical and H-O model rationales are put together, the basis for trade arises from differences in production possibilities (different technologies and/or factor endowments) that yield different price sets among potential trading partners.\footnote{Note that in the classical and H-O models the basis for trade take into consideration only supply conditions, assuming similar consumption patterns between countries. However, there are also strong neoclassical arguments that present the basis for trade considering differences in demand conditions that can generate further gains from trade even between countries with similar production capacities (PPF), see Appleyard and Field (2001) for further discussion.} Welfare gains then generate in essentially two ways: first, welfare trade gains result from exchange (consumption gains) when consumers are exposed to new relative lower prices coming from the trading partner. This allows consumers from country A to reach a higher indifference community curve not possible under autarky (moving from $CI_1$ to $CI_2$ in figure II.1). Second, welfare trade gains generate from specialization (production gains), resulting from resource allocation towards the production of the relatively more efficient commodity, increasing overall production efficiency (moving from $E$ to $E'$ in figure II.1) (Appleyard and Field, 2001).
The following standard trade diagram represents a graphic illustration of the positive welfare effects embedded in TTT, setting the basic argument for countries to pursue trade interaction as opposed to remain in autarky (figure II.1).

**Figure II.1. Welfare Effects of Trade on a Country (A)**

In autarky, country A is in equilibrium at point $E$, producing and consuming at the maximum level possible. With the opening of trade, it now faces the international prices, $(P_x/P_y)_2$. Given the relative higher international price of the $X$ good, production moves to $E'$, the point of tangency between the international prices and the PPF. At the same time, the $Y$ good is relatively less expensive at international prices, so consumers increase their relative consumption of it and begin consuming at point $C'$, where the terms of trade are tangent to the highest community indifference curve possible. $C'$ lies outside the PPF and is obtained by exporting the amount $x_3x_2$ of the $X$ good and exchanging it for $y_2y_3$ imports of the $Y$ good. The country is clearly better off because trade permits it to consume on the higher indifference curve $CI_2$. The similar (opposite) effects occur for the trading partner (Country B), which specializes in the production of good $Y$, (Source: Appleyard and Field (2001, p. 84)).

Of course, this is an over simplistic representation of the arguments behind TTT and without a doubt there is a lot more to the content of trade theory. However, for the purpose of my argument this illustration suffices to demonstrate that, according to TTT, the key objective of a PTA should be to increase trade among members to derive welfare gains. In other words, if a PTA increases trade among members, it then becomes conclusive that both countries will be better off. But the question is, can a simple welfare improvement derived from resource allocation be considered as a step forward to enhance economic development?

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14 For a more extensive textbook version of trade theory, see for example, Appleyard and Field (2001).
2.1.2. Economic Development and TTT

As discussed in Chapter I, economic development is the primary objective of DCs when forming PTAs. TTT predict that increased trade improves the well-being of a country. By definition, the goal of PTAs is to increase trade among members. Thus, according to TTT, PTAs could propel development. Note, however, that in a TTT framework, welfare gains derived from trade are subject to a series of assumptions hard to overlook when a certain PTA is to function as a motor for development. Especially because with these assumptions TTT fall short in explaining and incorporating obvious economic characteristics of most DCs, rendering their arguments, from a DC’s point of view, largely incomplete and oftentimes irrelevant. Therefore, it is important to point out some of these assumptions that are particularly relevant to DCs when opting for a PTA as a means to overcome some of the chronic features of underdevelopment such as, scarce technology and limited industrial resources to spur growth and employment rates.

First of all, TTT assume “full-employment” of factors of production. By doing so, they do not consider the persistently high levels of unemployment in most DCs.\(^\text{15}\) As Stiglitz and Charlton (2005) point out, with high unemployment one does not need to redeploy resources to put more resources into the efficient sectors (i.e. export sectors). One simply needs to employ hitherto unused resources. A simple liberalization of trade might not lower unemployment, especially in DCs where oftentimes the effective sectors lack the supply capacity to expand enough and absorb not only released resources, but

\(^{15}\) For example, Stiglitz and Charlton (2005) report that in 2001 average unemployment rates reached 14.4\% in Africa, 12.6\% in transition economies, and 10\% in Latin America. Moreover, he argues that such statistics, however, often under-represent the true level of unemployment – for instance, the prevalent high levels of disguised unemployment.
also initially idle ones. Trade liberalization might only lead the economy from low-productivity to zero-productivity – more unemployment.

Nonetheless, TTT strongly emphasize that the objective of trade liberalization is not to create additional jobs, but to increase standards of living by allowing countries to specialize in areas of comparative advantage. Monetary and fiscal policy should, in principle, enable countries to maintain the economy at nearly full-employment (Stiglitz and Charlton, 2005). For example, governments are supposed to compensate the negatively affected labor force through domestic redistribution policies such as, income taxes, retraining programs, and unemployment assistance. However, in practice, given the almost inexistent unemployment safety nets in most DCs, the faulty tax-collecting systems to improve them, and the low level of education investment, it is very likely that displaced workers will remain displaced after reallocation process.

Moreover, in relation to the employment of resources, not only full employment is assumed in TTT when a country opens up to trade, but it is also assumed that such resources will be costless and immediately reallocated. However, it is quite unrealistic to assume that a farmer will immediately and costlessly make him/herself available in an assembly plant where employment has been created from the manufacturing sector’s expansion. It is more likely that even if he or she is able to migrate, he or she will look for employment in the “same” sector (agriculture in this case, given the prior skill set),

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16 Townsend (2007) reports that most OECD countries spend in public social security in average about 15% of their GDP compared to about 2% in most DCs.

17 In average most OECD countries fund their public social security expending in average about 65% from tax-revenue, while most DCs (with the exception of China) average from 8-14% (Townsend, 2007).

18 Soubbotina and Sheram (2000) report that although DCs are devoting a larger share of their GDP to education efforts than in the past, they are still lagging behind developed countries – 3.3% and 5.4% respectively. Moreover, developed countries spend large amounts on private education subsidies.
where available. The migration would likely be towards the trading partner that has expanded this sector consequent upon a PTA. This is, oftentimes, one of the causes of international migration as opposed to internal migration (see Jansen and Lee, 2007).

Secondly, both the classical and the H-O models allow for the reallocation of the factors of production within the country but do not allow for mobility of the same across borders. This highlights an important limitation of TTT on analyzing the dynamics of current PTAs where capital is highly mobile across borders through foreign investments, but labor is not yet free to move internationally. This strongly favors the capital-abundant member of the PTA (the developed country), allowing it to move its resources to where they can be more efficiently employed, but disadvantages the labor-abundant member (the DC) by restricting the reallocation of labor to its own borders.

Thirdly, the H-O model, in particular, assumes identical production technologies across countries. Again, this model fails to capture a rather vital characteristic of underdevelopment – the lack of an efficient technological base in the economies of most DCs. A theory that takes it as a given is particularly unattractive to DCs, because most DCs tend to rely on exogenous technical changes which mostly occur in industrialized countries (Stewart, 1992). Hence, if PTAs are to be taken as a vehicle for development, there has to be some technology transmission variable that might allow technology spillovers from innovators to absorbers if a technological upgrading is to take place.

Lastly, TTT assume similar consumption patterns among trading partners. This implies, as Jayme (2001) points out, that demand structures are identical in all trading countries, which means that goods and services are consumed at given relative prices and

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19 See Lall (2000b) for further discussion on technology upgrading and development.
independent of income levels. However, if consumption patterns and preferences are purely measured by income levels, it becomes evident that high-income industrialized countries would have different preferences than low-income DCs. This is because most DCs are characterized by unskilled, low-technology, and labor-intensive production processes, generating low-income-characteristics goods, which might face limitations in penetrating high-income consumers from industrialized countries (see Chapter III).

In conclusion, once the general rationales of TTT are confronted with a dose of reality, it is extremely difficult to elaborate a correlation between PTAs and development through the TTT lens, especially because their very assumptions create a sort of retroactive and stationary mode of engaging in international trade and ignore altogether other aspects of economic integration such as capital and labor flows. As an overall message, TTT suggest that countries should exploit their initial comparative advantages and remain stagnant in doing so because it is initially beneficial. These theories do not leave much space for enhancing a country’s initial comparative advantage and progressively move forward. Otherwise, the incentive of welfare gains from trade is no longer relevant. As Stewart (1992, p. 70) states, “the prime concern of DCs is development (i.e. to change their factor endowments, their incomes, and their consumptions patterns), they tend to find a theory, such as the H-O, which assumes all these away as given and unchanging, particularly unattractive”.

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20 This reasoning is largely reflected in the works of Linder (1961) and the new trade theories of “Preference Similarities”, in which is explained that differentiated products are developed for the home market in accordance with domestic preferences. These preferences depend in large on income levels. Hence, the products are exported to markets with similar tastes (Stewart, 1992).
2.1.3. The Application of TTT to PTA Assessments

Notwithstanding the irrelevance of TTT to explain how welfare improvements derived from increased trade are to propel development and the fact that increasing trade is no longer the exclusive goal of today’s PTAs, the TTT framework still largely function as the primary benchmark for assessing the effects of most PTAs today. Indeed, most assessments of current PTAs focus on whether and how their particular mixture of trade liberalization and discrimination alters economic welfare by creating or diverting trade.

These advancements on PTA assessments are mainly attributed to the seminal works of Jacob Viner (1950) who noted that, since PTAs liberalized trade preferentially, they “create”, on one hand, new trade between PTA members while, they “divert” trade, on the other. The former effect takes place whenever a PTA leads to a shift in product origin from a domestic producer whose resource costs are higher to a member producer whose resource costs are lower. This shift represents a movement in the direction of efficient resource allocation and thus is presumably beneficial for welfare. The latter effect takes place whenever there is a shift in product origin from a non-member producer whose resource costs are lower to a member country producer whose resource costs are higher. This movement represents a movement away from efficient resource allocation and could reduce welfare. Since both trade creation and trade diversion are possible within a certain PTA, PTAs are considered “second-best” because they represent only a partial movement to free trade (Appleyard and Field, 2001).²¹

²¹ In fact, opponents of PTAs argue that these discriminatory schemes distract (or even subtract) from the optimal welfare gains that could be obtained from a truly open global system. As such, PTAs are seen as “stumbling blocs” as opposed to “building blocs”. An adequate discussion of these arguments is out of my scope here, for more details see for example, Krueger (1999a) and Bhagwati (1992).
Whether or not PTAs produce net welfare benefits to member countries is still an empirical issue. However, the majority of the few studies undertaken\textsuperscript{22} have tended to report small effects on both members and non-members, with net trade creation being the more likely outcome, and generally positive, although small, overall welfare gains, specially for N-S PTAs (UNCTAD, 2007b). Nevertheless, several empirical studies on S-S PTAs have resulted in trade diversion and hence, welfare losses (see below).

However, is this predominant case of trade creation and trade diversion, mainly based on static welfare effects, sufficient to truly capture and assess the development drive of current PTAs? Certainly not, I argue in this thesis. Rather, a broader approach that incorporates other aspects included in current PTAs on an individual PTA basis could be proven more appropriate.

There is one thing in common between assessing a certain PTA from a static perspective and assessing it with an alternative approach, as the approach used in this research. That is, a different PTA (i.e. N-S and S-S) will result in a different overall developmental outcome for the DC, but that outcome might be the opposite. For example, in a static assessment, N-S PTAs might offer welfare gains because it potentially “creates” trade among members. However, as discussed in more detail below, increased trade resulting from the PTA does not necessarily imply increased market access for goods and services that can beneficially influence the development of the DC. Rather, other factors and circumstances (potential PTA costs), which are neglected in static assessments, can easily turn around the net outcome of a N-S PTA, and potentially even hinder the development efforts of the DC involved.

\textsuperscript{22} See for example, Eicher et. al. (2007); Fugazza and Vanzetti (2006); Cernat (2003); and Mayda and Steinberg (2006).
In contrast, the developmental outcome of S-S PTAs from a static assessment is quite inconclusive. Some studies, such as Lo Turco (2003) and Mayda and Steinberg (2006) conclude that S-S PTAs mostly lead to slower growth among members because of their potential to “divert” trade. Other assessments, such as Fugazza and Vanzetti (2006) and Cernat (2003), report enormous potentials for trade creation and thus welfare gains. However, again, these assessments fail to consider any other factors and circumstances in PTAs beyond trade that can reveal extra developmental potentials from S-S PTAs, perhaps not by increasing the gains, but by reducing the costs of trade liberalization.

2.2. Constructing an Alternative Approach to PTA Analysis

It is now evident that, for the purpose of this research, a complementary theoretical approach to static welfare gains from trade has to be constructed in order to present a theoretical framework from which to improve the general understanding of how economic integration might enhance economic development. Because, as pointed out by some, a truly economic integration process includes many other aspects beyond trade matters that cannot be fully captured by conventional assessments. Perhaps, PTAs are not precisely to be considered as full economic integration, but they do currently include many other aspects beyond trade integration (Chapter I).

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23 For example, these studies report that, since tariffs among DCs in average are higher (11.1%) compared to (4.3%) between developed countries, there is more space for further liberalization. Moreover, trade among DCs has grown faster than both between developed countries and/or DCs and developed countries, 12.5%, 7%, 9.8% respectively. These studies estimate that a 10% tariff cut could be associated with a 1.6% increase in world exports between DCs. This could be translated as additional US$5.7 billion net gains; interestingly, the data indicates that an equivalent tariff reduction in N-N and/or N-S trade could have a smaller impact on trade flows and welfare gains. Welfare gains could total as much as US$35 billion from a S-S liberalization, compared to US$22 billion from a N-S liberalization (Fugazza and Vanzetti, 2006).

24 See for example, Kondonassis (2001).
By no means can it be possible to construct an alternative approach that does full justice to measuring the effects of PTAs on development. However, to restrict any evaluation to a single variable (trade effects) might not be quite enlightening either. As far as DCs are concerned, a “PTA Theory” needs to consider general development effects beyond the obvious welfare gains from allocation efficiency. These include accumulation of physical and human capital, learning to develop future endowments to change the initial comparative advantages, employment, and technology acquisition (Stewart, 1992). Therefore, in this section, not only is a dynamic approach as opposed to static approach to the effects of increased trade embraced, but also an additional important aspect of economic integration is considered – international capital flows.

There is increasing literature that has attempted to capture both the economic effects of the so-called “dynamic” trade gains and the implications, beneficial or harmful, resulting from international capital flows, but this literature has not yet been specifically directed towards the study of PTAs and development.

On one hand, some studies, mostly derived from the marriage between new trade and endogenous growth theories, have tried to individualize these dynamic trade gains, mainly by highlighting two concepts: “scale economies” and what is referred to as “trade-knowledge”. The former, as Jayme (2001) points out, plays the core argument of new trade theories, which strongly stress the importance of “increasing” returns to scale as a determinant factor for long-term growth. The latter refers to additional forms of capital, human capital and technology, that can endogenously propel long-run growth and

25 See for example, Baldwin (1993b); Nordas et. al. (2006); Wacziarg (2001); and Venables (2001).

26 However, Deraniyagala and Fine (2001, p. 811) point out that if sectors characterized by scale economies are not affected by the liberalization process, this type of dynamic gain will not materialize.
development. On the other hand, several studies have identified the important role that international capital flows are currently playing in the domestic-investment-dynamics of most DCs. Most importantly, these flows have been widely recognized to potentially offer an array of “dynamic side” benefits for economic development.

But how can the formation of a PTA allow these dynamic benefits to be directed towards development? For the purpose of these research, I have selected two rather common “delivery-vehicles” (as I will refer to them throughout this paper) that could facilitate the flow. These are “Market Access” and “Foreign Investment”, which I will discuss in turn below, aiming at constructing a more “realistic” theoretical framework from which to evaluate the impact of PTAs on economic development.

2.2.1. Delivery-Vehicles: Market Access and Foreign Investment

Today, the two main reasons for DCs to form PTAs are to obtain increased access to the partner’s markets and to attract foreign investments. Hence, it is essential to analyze the potential (positive or negative) effects on development that this implies.

A). Market Access: As Cadot et. al. (2005) point out, the perception of “increased market access” in recent years has gained a lot of popularity in international trade discussions as one of the core conditions to obtain from economic integration by DCs, for that it is heralded as the key for their successful integration into the world

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27 These concepts have been largely pioneered by several authors such as, Krugman (1990); Grossman and Helpman (1990; 1991); Rivera-Batiz and Romer (1991).

market. From a development perspective, market access is basically seen as the opportunity to overcome the “smallness” chronic problem of many DCs’ domestic markets and the many drawbacks that a small market represents (see UNCTAD, 2005). The formation of a PTA offers a real and immediate opportunity to “enlarge” the size of the market and reap the diverse benefits that come with it. As such, increased market access represents one of the “delivery-vehicles” that could bring about several dynamic benefits from international trade, such as physical capital formation, employment, and skill and technology spillovers (see next section).  

However, increasing literature warns of the fact that an enlarged market resulting from a PTA does not necessarily imply actual increased market access for those sectors that can benefit the development prospects of DCs. The formation of a PTA might well result only in net increased trade flows for the trading bloc, but oftentimes, market access for many DCs to the partner’s markets is restricted by many other factors, such as supply capacity constraints, and/or consumption patterns differences (see below). 

Moreover, market access for the DC can be further influenced by the type of PTA that is formed (N-S or S-S). Certain characteristics of each type of PTA will have a determinant impact on the level of market access that the DC obtains. For example, the principle of reciprocity that both N-S and S-S embrace, the restrictiveness of Rules of Origin (RoO), and any trade distorting measures such as subsidies and other non-trade barriers will all have an impact (see Chapter III, UNCTAD, 2007b, and Khor, 2007).

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29 Moreover, Bernard et. al. (2007) argue that, with an enlarged market, aggregate productivity will raise from the survival and expansion of effective firms. Note, however, that this argument assumes that DCs have effective firms capable of expansion. Also, this argument does not allow for weak firms to evolve.

30 See for example, Cadot et. al. (2005); and Estevadeordal (1999); and UNCTAD (2005).
B). Foreign Investment: Few doubt that investment is one of the most, if not the most, determinant factor for growth and development. Nonetheless, it is also true that one of the main constraints of most DCs is the lack of both public and private adequate domestic savings to generate the necessary investments. Recent findings show, on one hand, that overall public investment has been declining, as a share of GDP, in the developing world over the past two decades. On the other hand, recent research demonstrates that private domestic investment has not compensated for the drop of public investment as it was hoped (Roy, et al., 2006).

This has permitted the role of Transnational Corporations (TNCs), as source of capital for DCs, to grow over time (Lall and Narula, 2004). This, as mentioned before, has rendered foreign investment from TNCs (perhaps the most important form of international capital flows) crucial in calculating the dynamic benefits that can be obtained by DCs from a PTA, making it another important delivery-vehicle of benefits from economic integration and/or PTAs.

Foreign capital inflows into DCs from TNCs come mainly in two forms, namely Portfolio Investments and Foreign Direct Investments (FDI), which are further subdivided into Mergers and Acquisitions (M&As) and Greenfield Projects. The effects on development resulting from these types of foreign investment greatly vary from one another. The former, for example, has been identified as having an ambiguous

31 Robust empirical evidence is reported in UNCTAD (2003, p. 61) showing that investment is one of the few variables that independently and significantly impact the rate of economic growth. These include: Levine and Renelt (1992); Sala-i-Martin (1997); and Ros (2000).

32 According to UNCTAD, OECD, and IMF standards, Portfolio Investment refers to equity ownership of a company without obtaining the managerial control of the entity. FDI gives managerial control of the entity to the foreign investor.
and immeasurable impact on development, for that international capital markets are quite volatile and their final impact on an economy is quite difficult to capture.³³ Therefore, I will largely omit any comprehensive discussion of this type of foreign investment in this research. However, reference will be made when necessary.

The latter, on the other hand, has been largely identified as the main facilitator of dynamic development gains for DCs, mainly in the form of Greenfield projects, which in turn, according to UNCTAD (1999), enter an economy in four main types: i) natural-resource-seeking investments, ii) market-seeking investments, iii) strategic-asset-seeking investment, and iv) efficiency-seeking investments. Note that each of these types of FDI will generate different kinds of externalities for the host economy in technology, employment, and physical and human capital accumulation (see below).

However, DCs have to attract such investments in the first place, which mainly depends on domestic capabilities,³⁴ matching the wants and needs of foreign investors. Thus, it is very important to strongly emphasize that the mere formation of a certain PTA with investment provisions and/or separate investment schemes will not automatically guarantee inflows of foreign investment. Indeed, there is little evidence supporting this argument.³⁵ Rather, FDI tends to respond where local capabilities are strong when trade liberalization takes place and feeblest where they are weak (Lall and Narula, 2004).

³³ See for example, Weisskopf, 1972 (in UNCTAD, 1999, p. 31).
³⁴ See for example, UNCTAD (1999); Miyamoto (2003); and Plummer and Cheong (2008) for a detailed discussion on FDI determinants.
³⁵ UNCTAD (1998), Hallward-Driemeier (2002) (in Stiglitz and Charlton, 2005, p. 150), and more recently Plummer and Cheong (2008) found little evidence that Bilateral Investment Treaties (BITs) increased foreign investment inflows into DCs. However, Lesher and Miroudot (2006) make an important distinction between BITs and investment “provisions” in PTAs, reporting that the former does not have an impact on FDI flows, but that the latter are positively associated with FDI flows.
Nonetheless, the fact that DCs enter a certain PTA, oftentimes is perceived by foreign investors as a positive factor that might increase the rate of return to their investments. In addition, as reported by UNCTAD (1999), there are certain location-specific advantages of individual countries that play an important role in attracting FDI. Among these are some that can be enhanced by PTAs, such as the size of the market in which TNCs can operate allowing the realization of scale economics, productivity of local producers increased from resource allocation, and local cost-efficient factors of production made more available by the opening of the economy.

Yet, attracting FDI is only the first part of the process that allows DCs to benefit, a process that is subject to numerous conditions. For example, the “quality” of the FDI generates more benefits as opposed to the “quantity”. Moreover, as in the case of market access, there are some particular characteristics embraced in many PTAs that include investment provisions, such as expropriation clauses, national treatment, performance requirements, and transfer-pricing, that will further influence the level of benefits that can be obtained from increased inward FDI, enhancing or hindering its impact on development. Furthermore, UNCTAD (2006d) points out that the origin (developed or DCs) of inward FDI might further influence its benefits to the host economy. Ultimately, once more and better inward FDI has been attracted, the final and real impact on development will largely depend on the host-economy’s absorbing capacity and the overall proactive involvement of domestic governments to ensure the realization of such benefits (see section 2.2.3).

36 This reasoning is largely attributed to Dunning (1981, 1993a, and 1993b) (UNCTAD, 1999, p. 5)
37 See chapter IV for further discussion as well as Khor (2007); and UNCTAD (2007b).
2.2.2. “Potential Dynamic” Gains from PTAs

There are four potential dynamic sets of gains that can directly and positively affect the development efforts of DCs when entering a PTA. Both market access and FDI can contribute in delivering them in several ways. These include physical capital formation and economic activity, employment, technology spillovers, and human capital and skill enhancement, which are discussed in turn below.

1). Physical Capital Formation and Economic Activity:

One of the fundamental teachings of neoclassical growth theories is the indispensable role of physical capital accumulation in the enhancement of economic growth. Though still not sufficient, as later argued by endogenous growth theories, it is still a determinant factor of growth (UNCTAD, 2007b). PTAs, by enlarging the market and possibly attracting FDI, can play a determinant role in forming new physical capital.

First, an enlarged market allows DC’s producers to reap larger gains from scale economies. According to Ethier (in Stewart, 1992, p. 89), “the size of the global market is the limiting factor in determining specialization and economies of scale”. Gains from scale economies can potentially increase profits and the rate of private investment, which can generate physical capital (UNCTAD, 2003). However, as noted by Deraniyagala and Fine (2001), these gains are subject to the number of industries characterized by scale economies in the country and to the positive inclusion of those industries in the liberalization process. Moreover, Bernard et. al. (2007) argue that trade liberalization triggers a certain reallocation of economic activity across firms, which can raise aggregate productivity from the expansion of high-productivity firms and the contraction
of low-productivity firms. Nonetheless, DCs can be disadvantaged (i.e. in a N-S PTA) in benefiting from both scale economies and/or aggregate productivity, since they typically have few industries and firms that can exploit these benefits.

Secondly, foreign investment inflows potentially attracted by the PTA, as discussed previously, might directly affect the domestic rate of savings and investment, generating physical capital. However, the impact might be small, especially if the inflows are in the form of portfolio investments. For example, UNCTAD (1999) reports that, in the ‘90s, large capital inflows into several DCs did not generally lead to increases in total investment, and actually, domestic saving fell. If foreign savings merely crowd out domestic savings with no change in investment rates, the usefulness of foreign capital for capital formation, a key factor in development, can be questioned. On the other hand, if the inflows are in the form of FDI, particularly Greenfield investments as opposed to M&A, foreign investment might have a more positive impact on physical capital formation; yet, the effect might still be small due to the fact that on average FDI accounts for only 3% of GDP (UNCTAD, 2007b). Nonetheless, FDI can still stimulate economic activity by creating backward and forward linkages with the domestic economy.

2). Employment and Wages:

As previously mentioned, TTT are quite ambiguous in regards to the relationship between trade and employment. This ambiguity results from the fact that TTT were not concerned with the reallocation process of labor itself (i.e. the loss of jobs and the process of finding a new one), as Jansen and Lee (2007) explained. Rather, this process was assumed to take place instantaneously without any effect on employment. However,
during transition periods, trade liberalization can have significant effects on employment if the economy is not characterized by full-employment, or if some domestic policy or labor market failures hamper the adjustment process. Moreover, although TTT presumably do not allow for an effect on the “quantity” of jobs, they do imply an effect on the “quality” of jobs, better or worse paid jobs, as a result of trade liberalization.\textsuperscript{38}

Thus, in this context, it can be concluded that trade liberalization, and therefore PTAs, do affect the level of employment as well as wages. Hence, if strategically approached, PTAs have the potential to help DCs overcome the initial unemployment problem and create better paid jobs when liberalizing trade. Of course, in order for this to take place successfully, the economic integration process needs to be accompanied by a coherent set of structural and social policies (Lee, 2005).

First, as already mentioned, PTAs can enlarge the size of a DC’s local markets. This, in theory, could potentially allow the efficient exporting firms from DCs to expand enough and absorb not only displaced labor resources, but also some of the initially idle ones. Of course, the extent to which “efficient” firms take advantage of exporting opportunities is subject to many other factors, such as supply capacity constraints.

Second, FDI projects in certain sectors, like call centers and other labor-intensive activities, have the tangible effect of creating local employment without releasing any employed labor. In addition, as mentioned before, FDI has the potential capacity to increase commercial activity by creating linkages with the domestic economy. This can potentially increase the demand for domestic labor by expanding domestic firms in order to supply the newly established foreign firms (UNCTAD, 1999).

\textsuperscript{38} For further discussion, see for example, Jansen and Lee (2007); Lee (2005); and Ghose (2000).
3). Technology Spillovers and Innovation:

Perhaps the most highly desired benefits that DCs seek from closer integrating into the world economy are in the area of technology. TTT, like the H-O model, assume similar technologies across borders; hence, it undermines the one main requirement for growth and development as strongly affirmed by endogenous growth theories, which largely base economic growth on technological change. Moreover, UNCTAD (1999) reports that contrary to what neoclassical growth models postulate, technology is not a free good that is available for use by producers everywhere because it cannot be traded like a physical product. Instead, technology markets are opaque and often subject to information failures.

In turn, new trade theories such as “learning economics” put forward mainly by Westphal (1982), Stewart (1982), and Krugman (1984) have recognized the potentials of international trade to help alleviate the backwardness of most DCs’ technological base (Stewart, 1982). In essence, these theories argue that DCs can greatly benefit from international trade by “learning” from the international-technology power house. This can happen in several ways by increasing market access and foreign investment inflows.

First, international trade allows exposure to a greater variety of traded goods from both imports and new domestic products developed to serve the enlarged market. This increased variety of commodities embraces a great deal of embedded technology (knowledge capital) that could be absorbed by utilization and/or reverse engineering. Grossman and Helpman (1990; 1991) argue that benefits accrue in an industry and an economy through “trade-knowledge”. This trade-knowledge includes, and can be modeled as, gains from foreign R&D embodied in traded goods, technology transfers
through trade, process innovation, best practice implementation, and imported intermediate goods of variety and quality. Note, however, that this requires an initial minimal R&D base, strategic investment towards R&D efforts, and a minimal absorbing capacity, human capital, something in which many DCs lag behind, as it will be discussed in the next section (also see Deraniyagala and Fine, 2001).

Second, as Lall and Narula (2004) point out, TNCs continue to dominate the creation of technology; indeed, with the rising costs and risks of innovation, their importance has risen. Hence, FDI inflows from TNCs can potentially generate substantial “spillovers” not only of new technologies, but also of the technical know-how to operate them. New established plants bring along new machinery and, perhaps, new processes that allow for more efficient operation of existing domestic technologies.

Nonetheless, technology transfers from both increased trade commodities and FDI projects can be hindered by the very PTA that has generated them, meaning that burdensome IPR packages included in the PTA might well block any technology transfers. This might have a greater impact in the case of N-S PTAs, which involves large technology creators with usually stricter regulations that protect that technology. Northern countries might carry on their domestic legislation on IPR to DCs when forming a PTA hindering technology transfers (see Chapter IV).

4). Human Capital and Skill Enhancement:

The level of human capital that a country possesses is one of the few variables empirically tested to have a determinant impact on the rate of economic growth.\footnote{Miyamoto (2003, p. 44) lists several studies supporting this argument.}
Indeed, human capital accumulation is the other key factor of endogenous growth theories, as mentioned before. Although it can only be mainly developed from within, and although it is actually a prerequisite to benefit from economic integration (see next section), it can also be enhanced by positive externalities when economic integration takes place, thereby creating a prosperous cycle, as Miyamoto (2003) argues.

First, a larger market will generate increased productivity resulting from resource allocation, but most importantly, from increased “specialization”. As Stewart (1992) points out, Adam Smith demonstrated with his pin-production example that division of labor enables specialization, which in turn pushes “repetition” of certain tasks, allowing individuals to acquire higher levels of skill and learn new methods to produce commodities more efficiently. But, as Adam Smith noted, such specialization is limited by the extent of the market; the size of the market determines how much division of labor and specialization is justified.

Secondly, and certainly more importantly, FDI from TNCs (mainly Greenfield projects) is likely to introduce more sophisticated managerial practices and high-skilled personal. Local labor can greatly benefit from learning-by-doing, and imitation. Moreover, a great part of FDI projects, especially in the manufacturing sectors, include some sort of “training” for the employed local labor, increasing the general skill level and technical know-how (UNCTAD, 1999).40 In addition, Miyamoto (2003) reports that TNCs not only contribute to skill-enhancement of the local labor force, but they also engage oftentimes in supporting formal education.

40 A report done by the World Bank, “World Business Environment Survey”, shows that approximately 60% of firms in both East Asia and Latin America regions conducted some formal training in the year 2000 (Batra and Tan, 2002; Batra, 2003, in Miyamoto, 2003, p. 19).
2.2.3. From Theory to Practice

Theory is quite difficult to put into practice; hence, it is not to be assumed that DCs will be able to materialize the abovementioned gains. As UNCTAD (2007b) notes, an efficient development path requires more than mere “external integration”. This is because benefiting from external development forces is strongly preconditioned by an intensive “internal integration” process, which implies expanding domestic markets, shifting patterns of employment, improving infrastructure, and creating a dense domestic network of input-output linkages. By the same token, internal integration needs to be supported by strong economic-socio-political institutions and proactive governments.

A). Absorbing Capacity: This characteristic will largely determine the realization of potential dynamic gains that can be generated from FDI inflows. As briefly mentioned before, there are different types of FDI and they all offer different positive externalities to the host economy. However, this will be determined not only by the “quantity” of the FDI attracted, but most importantly, by the “quality” of it.

For example, natural-resource-seeking FDI, which refers to projects of extraction and processing of natural resources, has been traditional related to large amounts of capital-intensive projects with little impact on the host economy as far as employment and technology spillovers.\(^{41}\) Besides, they require some kind of natural resources endowments in the host economy, which might not always be the case. On the other

\(^{41}\) Also, as stated by the Prebisch-Singer hypothesis, the concentration on the production and export of natural resources and raw materials, with time deteriorates the terms of trade for DCs. Partially, this is because new technologies have replaced many natural raw resources with synthetic products, thereby decreasing the world demand for the former (Appleyard and Field, 2001).
hand, market-seeking and strategic-asset-seeking FDI\textsuperscript{42} might bring an array of benefits impossible to obtain without such FDI, because these are internal to TNCs. For the former, these include new technologies and/or new methods of operating existing ones, international market networks, backward and forward linkages, established brand-names, managerial know-how, and employment opportunities. The latter includes mostly R&D increased capabilities. However, the attraction of these types of FDI usually requires large domestic markets and certain \textit{high} levels local capabilities (UNCTAD, 1999).

Efficiency-seeking FDI will be largely discussed in this research since it is the type that historically has been most easily attracted by DCs. It mainly occurs when TNCs locate part of their value-added production chain abroad in order to improve their profitability. The oldest of such investments have been labor-seeking investments. As wages rose in home countries, TNCs sought to obtain access to low-cost labor DCs by locating in them the labor-intensive segments of their production processes. Attracting this kind of FDI is usually easier for DCs, since they are characterized by a labor surplus which makes it cheap and attractive to TNCs.

However, the benefits of this kind of FDI can be questioned because of its two potential outcomes. On one side, it can bring several benefits, as UNCTAD (1999) points out, the shifting of labor-intensive processes to DCs has probably been the most important factor behind the growth of their manufactured exports in the past three decades. Most importantly, this type of FDI is particularly attractive for its employment creation feature by employing idle labor resources. On the other hand, the fact that this

\textsuperscript{42} Market-seeking or “tariff-jumping” FDI basically relates to the establishment of foreign affiliates in the host economy to expand their market share and increase their competitiveness from reduced transport and tariff costs. Strategic-asset-seeking FDI mainly occurs in R&D areas (UNCTAD, 1999).
FDI is mainly attracted by a static comparative advantage (cheap-labor), oftentimes means that the benefits from it to DCs diminish or altogether vanish once the static comparative advantage is exhausted (when wages rise).

To this end, it is needless to stress the role that a country’s capabilities play in attracting FDI (quantity), but most importantly in the type of FDI that will be attracted (quality) and the capacity to retain that investment. Lall and Narula (2004) point out that absorptive capacity is significant for development because it allows domestic actors to capture knowledge that exists elsewhere. Where absorptive capacity is lacking in domestic firms, they may, instead of reaping technological benefits from FDI, be “crowded out”. Capabilities in the host country context matter for the magnitude and intensity of technological updating. Lall and Narula (2004) further report that several authors have noted that a minimum level of scientific and technical knowledge is required to use innovation. Below this level, the cost of adoption can be prohibitive.\(^{43}\)

Moreover, Saggi (2002) stresses the difference between technology “transfer” and technology “diffusion”. This means that technology might be internationally transferred through various channels, but will not necessarily be diffused throughout the rest of the economy. Domestic actors play a critical role in this process, where the level of human capital within the economy will largely determine its diffusion. In addition, as previously mentioned, the process of technology diffusion can be hindered by the set of burdensome IPR packages embraced in a certain PTA. IPR regulation might well allow the technology transfer to take place within the TNC and/or to certain enclave sectors, but the diffusion to the rest of the economy might be restricted.

\(^{43}\) Other studies reported in Lall and Narula (2004) present further empirical evidence of the need of a minimum absorbing capacity in order for DCs to be able to absorb benefits from FDI.
B). Supply Capacity Constraints: This characteristic will largely affect the realization of dynamic gains that might result from an enlarged market simply because the country is not able to respond to the increased demand (i.e. scale economies and aggregate productivity, p.28-29). Most DCs lack important elements that constitute the overall local producers’ capacity not only to initially respond to a larger demand, but also to increase their existing potential. These elements include general infrastructure, such as an extensive transportation network of roads and speedways, capable port infrastructure, widespread communications networks, and reliable and efficient power and water supplies that will initially enable producers to serve the enlarged market.44 Moreover, accessible and well functioning credit markets are a determinant element since financing is critical in both expansions and new start-ups.45 Also, labor mobility (efficient transportation) needs to be improved, allowing displaced workers to more easily move to exporting sectors where they might be needed.

If the abovementioned conditions are nonexistent or inefficient, the potential benefits from economic integration become obsolete when enlarging the market. Supply capacity constrains might even have negative effects, especially when entering a PTA with a supply-capable partner (i.e. N-S PTA). In a N-S PTA, the DC might not be able to respond to market access opportunities, but what is worse is that its domestic markets are vulnerable to swamping by the northern country’s competitive and abundant products (Fugazza and Vanzetti, 2006). This might further press down weaker domestic producers. On the other hand, in a S-S PTA there may be many missed opportunities due

44 For a detailed discussion on adequate infrastructure and supply capacity as well as differences between DCs and industrialized countries see for example, World Bank (2008b); and UNCTAD (2005).

45 See World Bank (2008a); and UNCTAD (2005) for a detailed discussion on credit restraints in DCs.
to supply capacity constraints, but at least there is no significantly superior supply-capable member to swamp the other members’ markets. Hence, it is important to stress that if there are significant pre-existing production asymmetries among PTA members, not only the weaker partner misses out of the opportunities, but also the stronger party might get the lion’s share of the benefits (see Chapter III).

**C). Government Intervention:** The ultimate element in realizing dynamic and/or static gains from economic integration (PTAs in this case), delivered by both market access and foreign investment, is the proactive role that domestic governments play in the entire odyssey.\(^46\) Making sure that an economy maximizes the benefits, or at least diminishes the costs of all aspects of economic integration, is a job that cannot be done by any theory, but only by local governments in interaction with their business communities and social institutions. There are some areas in which a proactive role of the government can be essential to benefit from full or partial economic integration.

First, before opting for across-the-board trade liberalization program hoping that it will promote development, domestic governments need to *a priori* assess, and to “design”, so to speak, the direction and form of trade liberalization that they need. This requires extensive “economic” knowledge about their potentials and weaknesses and not just “political” support. Eventually, this can give insights as to what sectors to liberalize, under what terms, and whether the benefits will not be outweighed by the costs, thus, designing beneficial liberalization schedules with enough built-in flexibility. Of course,

\(^{46}\) Authors such as Hoekman (2005); Lall and Narula (2004); Lall (2000a), and reports such as UNCTAD (1999, 2005, and 2007b) very much stress the important role that domestic governments should play in realizing the benefits from economic integration.
this is by no means an easy task, especially when negotiating N-S PTAs. Northern countries are oftentimes not interested in a PTA with a DC mainly due to the low incentives from a small market, unless advantageous concessions are offered, which automatically results in a disadvantageous agreement for the DC. Hence, forming S-S PTAs offers a “fairer” negotiating setup. As I argue throughout this thesis, the developmental benefits of PTAs are not only determined by theory, but largely by the outcome of negotiations in designing them, where bargaining power is likely to have an enormous real impact.

Second, trade theory has documented well that trade liberalization will result in winners and losers. Hence, the government needs to identify those losers and be ready to assist them in integrating into the reallocation process. This can be done by creating realistic safety nets, such as unemployment assistance, training programs, and overall increased investment in education, which ultimately will do both help individuals to be able to allocate into the new enlarging sectors and increase the human capital stock to better absorb the positive externalities that might come from the overall economic integration process, but specifically from inward FDI.

Thirdly, there is just so much that the private sector can do in taking advantage of new trade and investment opportunities and the benefits that come with them. As Hoekman (2005) stresses, governments should play a proactive role in interaction with the business community by helping to regulate the financial sector, investing in infrastructure projects, creating trade promoting agencies, and adopting overall follow-up policies to adapt to the new atmosphere created by the “reallocation” process of economic integration. This will ultimately increase the supply capacity of the private
sector so that it can better respond to trade opportunities and more beneficially interact with foreign investors. Moreover, one particular aspect in which the government can directly stimulate this process is by not liberalizing in the government procurement area and offering these projects exclusively to domestic suppliers, which can further stimulate the overall domestic economic activity (see Chapter III for more detail).

Summing up, by constructing an alternative approach to traditional PTA analysis, it has been shown that closer integrating economically (forming a PTA) can result in various potential “dynamic” benefits for DCs. PTAs might be able to put at the doorstep several of these benefits by enlarging the market, and potentially attracting FDI inflows. However, there are two conditions if theory is to be put into practice: i) market access needs to be actually exploited, which is not necessarily done by simply enlarging the market on paper by signing a PTA, and ii) good quality foreign investments need to be attracted, which is done by increasing local capabilities. However, even if these conditions are met, the ultimate developmental result from a certain PTA will only depend on domestic absorbing and supply capacities to respond to trade and investment opportunities and, on the proactive role of the government to shape the desired outcome.

With this being said, in the next two chapters, I will test this alternative approach by analyzing the actual characteristics of two current PTAs, namely NAFTA and ASEAN and its various trade and investment schemes, hoping to capture the developmental benefits that Mexico and the ASEAN economies have been able to obtain from closer integrating with their neighboring countries.
CHAPTER III: MARKET ACCESS ISSUES IN NAFTA AND AFTA

In Chapter II, market access was identified as one of the two vehicles that can potentially deliver substantial dynamic benefits to DCs from increased international trade. Thus, improving access to the markets of partner countries is one of the key motivations for DCs to pursue closer economic integration by forming a PTA.

Partially fueled by this line of thought, Mexico embarked on a mission of obtaining preferential access to one of the world’s largest markets, which was right next door, and kick-off its economic development process once-and-for-all by signing NAFTA. Likewise, partially based on the same rationale, but with a more cautious approach and with a likely smaller impact – given the market sizes – the ASEAN economies formed a Free Trade Area (AFTA).

However, after more than a decade from the creation of both agreements, the development process of Mexico and that of the ASEAN-10 appears to have been differently affected by each respective accord (see Chapter V). This despite the fact that both agreements seem to have had a major impact on the export-flows of both Mexico and the ASEAN-10 at the aggregate level (figures III.1 and III.2). On one hand, the

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47 The US and Canada combined registered in 1995, a nominal GDP of US$7.88 trillion, or almost one third of the world’s total GDP (UNCTAD, 2006a).

48 AFTA was formed in January 1992, the six initial members were, Brunei, Indonesia, Malaysia, the Philippines, Singapore, and Thailand. Vietnam joined AFTA upon its membership in ASEAN in 1995, Lao PDR and Myanmar in 1997, and Cambodia in 1999 (for more information on this and other ASEAN agreements go to: http://www.asean.org/4920.htm. The ASEAN-10 combined registered in 1995, a nominal GDP of US$ 676 billion, or 2.2% of the world’s total GDP (UNCTAD, 2006a).
increased export-flows in the case of Mexico do not seem to have delivered the economic performance results that many expected; instead, the Mexican economy has been performing worse than it did during some periods prior to NAFTA (see Chapter V). On the other hand, the increased trading activity during the period of AFTA, especially in the last years (figure III.2), seems to have been accompanied by an overall trend of significantly positive economic performance by all members, before and during the accord, compared to other similar DCs (see chapter V).

Figure III.1. Mexico’s and the ASEAN-10 Total Export-Flows

Source: Author’s calculations based on UNCTAD (2006a) figures.

Figure III.2. Mexico’s and the ASEAN-10 Annual % Export Growth

Source: Author’s calculations based on UNCTAD (2006a) figures.

Assuming that, to a certain extent, both accords were responsible for the increased export-flows experienced, and increased trade can be economically positive, the somewhat paradoxical results from Mexico support the presumption at which I arrived in

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49 In the case of NAFTA, many authors agree that it has been largely responsible for the export growth experienced by Mexico after its implementation. For example, see Ramirez (2003) and Krueger (1999b), to mention just a couple. In the case of AFTA, however, there are divided opinions. For example, Elliot and Ikemoto, 2004 (in Lendle, 2007, p. 6) suggest that AFTA had no impact on intra-ASEAN trade. Other studies, such as Cernat (2003) conclude that AFTA has positively influenced ASEAN’s overall trade flows.
Chapter II: increased trade/export-flows created by the PTA do not necessarily imply improved market access for the goods and services produced in the DC that can positively influence its development. Rather, there must be many other factors and circumstances that need to be put in place before and during the negotiating stage, if a PTA is to generate greater market access and development. Otherwise, market access opportunities offered by a PTA risk remaining only that – “opportunities”.

This chapter analyzes and compares crucial market access issues in both NAFTA and AFTA. It also points out the main differences between them, pinning down some of the reasons why they have delivered such different results, when the initial purpose was to some extent based on the same rationale. In order to have a meaningful comparison, the chapter is divided in three sections: i) the pre-existent circumstances in the run-up of the accords’ negotiations, ii) the actual text-structure of each agreement regulating market access, and iii) the final market access results generated in some of the most important economic sectors for DCs such as, trade in manufactures, agriculture, and services.

3.1. Pre-Existent Circumstances

The general approach to improve market access is the elimination of tariffs, and non-tariff barriers (NTB) to trade. However, obtaining access to foreign markets, especially for DCs, is a lot more complex than the mere reduction of tariffs and NTBs (Chapter II, p. 24). A country’s economic, social and institutional structure might well circumscribe the capacity to respond and capture any market access opportunities. Hence, the pre-existent circumstances and potentials of each negotiating member as well,
as the asymmetries among them would likely have a decisive impact on both the final text-structure of the accord and the actual results.

A). Bargaining Power: First and foremost, the level of bargaining power (in all respects) brought to the negotiating table will definitely draw the direction that any PTA will take, as far as drafting the actual text, which oftentimes could lead to a biased agreement in favor of the stronger party. This issue had a stronger impact in the case of NAFTA, where the economic muscle of the US and Canada was evident in several political and economic areas such as: i) larger and better structured domestic markets, ii) greater resources for the actual negotiating team, iii) more influential political and legal frameworks that prevent trade negotiators from liberalizing beyond a certain point, and iv) many and well organized lobbying groups. Due to these initial disadvantages, Mexico might have been forced to undertake a broader and deeper liberalization of its markets in order to obtain some preferential access to the US and Canada. In fact, this might have well eroded a great part of the benefits obtained from the accord.

In AFTA, the problem of bargaining power was lesser, given the fact that at least the five largest members were, and still are, at a similar stage of development and market size. They had similar negotiating skills, similar economic resources, and similar

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50 For example, the US Bipartisan Trade Promotion Authority Act of 2002. See Khor (2007, p. 8).

51 To better illustrate this point Panagariya (1998, p. 45) quotes Fred Bergsten (1997b, p. 26) as follows: “NAFTA amounted to a 4% expansion of the American economy, to include a country that accepted virtually every demand placed upon it in the negotiations and which made virtually all the concessions.”

52 When NAFTA was negotiated the US economy was about 27 times larger than that of Mexico, US$7.3 trillion, and US$0.28 trillion respectively. These asymmetries were smaller in the case of AFTA, especially among the five largest AFTA members (Indonesia, Malaysia, Philippines, Singapore, and Thailand) (UNCTAD, 2006a).
knowledge of their local markets. The weaker bargaining power aspect might have had similar effects on the later AFTA joiners, Vietnam, Laos, Myanmar, Cambodia, and also Brunei, the smallest economy; however, in AFTA, because it was a far less ambitious accord, the impact of harmful concessions was lower for the late joiners of AFTA than for Mexico under NAFTA.

B). Initial Tariff Levels: This pre-existing condition will likely have a negative impact on most DCs from liberalizing trade, due to the relatively higher tariff levels.\(^{53}\) A higher initial tariff rate implies a greater loss of revenue with two adverse effects. One, the lost revenue will offset a great part of the country’s net welfare gains obtained; two, it will further exacerbate the government’s financial ability to proactively assist its development, (Chapter II, p. 38). This is because tariff revenue is a very important source of the total government’s revenue of many DCs.\(^{54}\)

For example, before NAFTA, Mexico applied on average an 11% tariff to its future trade partners, compared to a 4% on average of the US and Canada to Mexico (UNCTAD, 2007b).\(^{55}\) In the case of AFTA, with the exception of Singapore and Brunei, all other founding members entered the accord with a substantially high tariff rate (table III.1). However, it is also interesting to observe in table III.1 that the late AFTA comers were permitted to further increase their tariffs for the first years and gradually decrease

\(^{53}\) The average trade-weighted average applied tariff by DCs is 8.1%, compared to 2.9% of developed countries (Fugazza and Vanzetti, 2006).

\(^{54}\) For example, Lao-Araya (2002) reports that on average DCs collect 16.15% of their total revenue from foreign taxes (tariffs), compared to about 0.89% in average in industrialized countries.

\(^{55}\) Panagariya (1998) reports that the redistributive effects of NAFTA due to its initial high tariff level might be costing Mexico as much as US$3.25 billion per year.
them later. This has made smoother the initial shock of lost revenue for the weaker members, such as Cambodia that collected on average 58.1% of its total revenue from tariffs (Lao-Araya, 2002).

Table III.1. Average Tariff Rate in the ASEAN-10 During AFTA

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<tr>
<td>Indonesia</td>
<td>17.27</td>
<td>17.27</td>
<td>15.22</td>
<td>10.39</td>
<td>8.53</td>
<td>7.06</td>
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<td>7.22</td>
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<td>7.15</td>
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<td>Lao PDR</td>
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<td>5</td>
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<td>6.72</td>
<td>5.86</td>
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<td>Myanmar</td>
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<td></td>
<td>2.39</td>
<td>4.45</td>
<td>4.43</td>
<td>4.57</td>
<td>4.72</td>
<td>4.61</td>
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<tr>
<td>Vietnam</td>
<td>0.92</td>
<td>4.59</td>
<td>3.95</td>
<td>7.11</td>
<td>7.25</td>
<td>6.75</td>
<td>6.92</td>
<td>6.43</td>
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<tr>
<td>ASEAN10</td>
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<td>4.11</td>
<td>3.84</td>
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Source: Hapsari and Mangunsong (2006)

C). Consumption Patterns Differences: TTT predict that a reduction in tariffs will increase market access and welfare gains from trade. However, as discussed in Chapter II (p. 17), if markets are differentiated by income levels, the possibilities of increasing market access (especially from low to high income markets) are largely reduced. As Mayer and Zignago (2005, p. 1) argue, “while tariffs still have in general an influence on trade patterns, our estimates suggest that they are not an important component of market access difficulties faced by Southern exporters on Northern markets”. Rather, complementary economies tend to trade more with one another despite the level of tariffs applied.

Two observations are worth mentioning in regards to NAFTA and AFTA that support this argument. Cuyvers and Pupphavesa (1996) report that AFTA has come about from a long historical cooperation among its members through ASEAN, which hardly generated any significant trade for the first 25 years or so. It was mainly due to the members’ non-complementary economies. However, after years of attempting to meet each others’ economic needs, intra-regional trade has been steadily increasing.
during the last decade (Figure III.1 and III.2), due not only possibly to AFTA, but also to the gradual complementation of the members’ markets.

In the case of NAFTA, since the Mexican economy already heavily depended on imports from the US before NAFTA, the US has greatly benefited from the accord. The agreement only made it easier for US exporters to penetrate the Mexican market. On the other hand, Mexico has only been successful in increasing its market access to the US on the assembly line, or Maquiladora plants, as I will explore later in more detail. It suffices for now to say that goods from the maquiladora sector can be hardly considered “Mexican”, since most parts are imported from the US. Most other Mexican products, excluding the oil sector, have performed quite poorly in penetrating the northern markets of Canada and the US. This was largely due to the lack of demand of Mexican commodities in those markets.

Some Mexican exporters, mainly exporters in the consumer goods sectors, such as typical and regional foods and clothing (i.e. consumer Mexican brands such as Corona, Jumex, Marinela, and Bimbo), have increased their market share in the US market since NAFTA (Salazar, 2004). However, they have done so not by capturing American consumers, but by serving the increasing demand generated from Mexican emigrants in the US that have more than doubled in numbers since the accord took place. In other words, these Mexican brands have been able to increase their sales to the very same domestic consumers that did not have the purchasing power when in Mexico. Ironically,

56 In 1990, Mexico imported 66.1% of total imports from the US (UNCTAD, 2006a).

57 Calculations suggest that exported goods from the Maquiladora plants on average contain a mere 1-3% of locally produced Mexican inputs (see Ramirez, 2003; and UNCTAD, 2007b).

58 Delgado-Wise (2004, p. 594) reports that since NAFTA the migratory flow over the past decade has been 10 times higher than the one recorded 20 years earlier.
Mexico had to enter NAFTA to generate an emigration wave and expand market access for wholly produced Mexican goods in the US, but American brands such as Coca-Cola, Frito-Lay, and even Taco-Bell had long before NAFTA captured the Mexican market.

D). Supply Capacity Constraints: In Chapter II (p. 36), it was concluded that a pre-condition in the capturing of opportunities of an enlarged market was the “readiness” of a country to do so. This readiness was composed of the physical infrastructure and credit markets available to local producers to respond to the new demand. However, it was also concluded that the average DC, including Mexico and the ASEAN-10, is less equipped with adequate infrastructure and credit markets than industrialized countries.\(^59\)

In the case of NAFTA, Mexican exporters were faced with US and Canadian exporters equipped with widespread and abundant transportation resources and sophisticated communications networks. Most importantly, US and Canadian exporters had at their disposal not only domestic strong credit markets, but also, oftentimes, access to international credit markets. Under these circumstances, Mexico might not only have lost many trade opportunities, but even worse it might have exposed its domestic markets to be swamped by US and Canadian products, further pressing down weak domestic producers (Chapter II, p. 37).

In the case of AFTA, there were many missed out trade opportunities by all members, but at least, there was no evident supply-capable member that was able to

\(^{59}\) For example, the US has about 0.67 thousand sq/km of roads and speedways per sq/km of surface compared to 0.18 of Mexico. On average high-income countries have 660 vehicles (both commercial and private) per 1000 inhabitants, compared to about 250 on average in DCs. 65% of firms from DCs reported infrastructure inefficiency as one of the main obstacles to operate. High-income countries have on average 55 telephone lines per 100 inhabitants, as opposed to 13 on average in DCs. In DCs, on average, 45% of firms reported credit access problems as opposed to only 17% in most industrialized countries (World Bank Statistics in Infrastructure at: \url{http://www.worldbank.org/}). See also Jansen and Lee (2007).
swamp the other members’ markets. Singapore is the only member that might have been superior as far as adequate infrastructure and credit markets, but given the small size of its economy, it is highly unlikely that it could have an impact such as the one of the US on Mexican markets.

3.2. The Texts Governing Market Access

Large asymmetries in all the abovementioned pre-existing circumstances among members of a future PTA will definitely generate different sets of rules and regulations governing market access opportunities, which ultimately will determine any developmental gains that each member will obtain. This has certainly been the case for NAFTA and AFTA which, although set out to accomplish similar goals, delivered somewhat different final results. Hence, it is important to analyze the main characteristics that each agreement embraces as far as market access and to point out the main differences that might have led to the different results.

According to Estevadeordal (1999), there are two basic parts of any market access agreement that will dictate and regulate trade among members: i) the preferential tariff level to be set and the phase-out schedule (Liberalization Schedule), and ii) the governing RoO that will evaluate if a commodity is generated within the borders of a member. In addition, there are some other important features that characterize most PTAs today, which will also have an impact on the final results of the agreement. These include the concept of reciprocity, government procurement, and the built-in flexibility that the accord offers to the weaker partner to gradually adapt to the initial shock. All these will be discussed in turn below.
3.2.1. Liberalization Schedules

Estevadeordal (1999) explains that, traditionally, the tariff level in PTAs used to be set at a fixed preferential level below the MFN rate. But the constant unilateral and multilateral tariff reductions had the effect of progressively eroding preference margins initially agreed upon. Hence, to maintain those margins over time, countries needed to constantly renegotiate the agreement (an issue that AFTA members are currently facing as discussed below). Later on, PTAs were based on constant relative margins of preference by negotiating preferential tariff reductions as a percentage of the MFN currently applied rates. In fact, most current PTAs have followed the NAFTA model in many respects, moving towards tariff phase-out programs that are relatively quick, automatic, and nearly universal. The tariff elimination process follows pre-specified timetables ranging from immediate elimination to up to generally 10 years period phase-outs, with special phase-out periods for those products regarded as “sensitive”. These are very important features of a PTA, for they permit or hinder, in the short-run, the weaker partner to adapt to an initial greater drop of tariff revenue and to increase its competitiveness in all the weak sectors before the phase-out period ends.

In the case of NAFTA, half of its 22 chapters\(^\text{60}\) regulate and specifically address in detail the list of items covered by the agreed tariff rate and when, if included in the accord, it applies. Also in the case of NAFTA, the set tariff rate was straightforward and members agreed on a zero tariff rate starting from their respective pre-NAFTA MFN applied tariff levels. The elaborated part of the agreement was the phase-out schedule under which parties agreed to phase-out their respective tariffs for the initially excluded

\(^{60}\) For a full copy of the NAFTA Text, go to: [http://www.sice.oas.org/trade/nafta/naftatce.asp](http://www.sice.oas.org/trade/nafta/naftatce.asp)
sensitive items. The parties agreed to put goods into several categories depending on their sensitivity to import competition, reflecting the magnitude of liberalization effect as well as the political weight of each sector. The four main NAFTA stages specifying the number of equal-size annual cuts until full liberalization were: A (immediate), B (five stages), C ten stages, C+ (fifteen stages).\(^{61}\) At the time of implementation on January 1\(^{st}\), 1994 tariffs for about half of all import categories were eliminated immediately, and most of the remaining tariffs were set to disappear within a period of five years. The most drastic phase-out was carried out by Mexico with initial cuts above 50% on average. The US, which had started with low tariffs, implemented an almost immediate full tariff liberalization, with the exception of specific sensitive sectors, such as food products, textiles, apparel, and footwear manufactures (Estevadeordal, 1999).

In comparison, the main instrument that regulates market access in AFTA is the Common Effective Preferential Tariff (CEPT). The preferential tariffs rate agreed by AFTA members was ambiguously set to 0-5%. The initial phase-out program was set to 15 years, but later moved up to 10 years for all members according to the date of accession of the CEPT program.\(^{62}\) In a fashion like NAFTA, the CEPT phase-out program was also divided in product categories, allowing gradual liberalization.

However, even in the CEPT inclusion product list there was much less immediate liberalization of goods. There are two phase-out routes for the CEPT inclusion list that allow members to immediately liberalize products under the “Fast-Track” or instead to

\(^{61}\) Quote from Estevadeordal (1999, p. 6): “It is interesting to note that it was the United States that insisted on C+ category. This embarrassed the US Chief negotiator who later said “it was as if we were the developing country,” reported in Mayer (1999 p. 117).”

spread out the liberalization process through the initial phase-out schedule of 10 years under the “Normal-Track”. There are three other additional liberalizing categories that allow for sensitive products to be excluded from the CEPT program: i) temporary exclusions list, which will gradually be reduced by 20%, annually moving these items to the general inclusion list over a five years period, ii) sensitive agricultural products, which will be extended with a deadline of the year 2010 for their integration into the CEPT, and iii) general exceptions, which are permanently excluded from liberalization (Cuyvers and Pupphavesa, 1999).

There are some important differences in regards to the preferential tariff and the phase-out schedules that NAFTA and AFTA have pursued and that would have generated the eventual outcomes on market access. First, the preferential tariff level in NAFTA was immediately dropped to zero for a great part of the product groups included in the scheme. This has, without a doubt, had a tremendous initial impact on Mexico, not only decreasing the tariff revenue, but also taking the risk of having liberalized too much too soon.\footnote{Froot (1989) empirically demonstrates that: “A gradual lowering of trade barriers turns out to be welfare-superior to an immediate liberalization”. Also, see Jansen and Lee (2007) for more detail.} In AFTA, the preferential tariff rate was set to 0-5%, not absolute zero. On one hand, this issue has drawn some negative attention from observers such as Hapsari and Mangunsong (2006), who argue that tariffs under the CEPT have been underutilized since the weighted preferential tariffs in AFTA were higher than MFN tariffs. On the other hand, it reflects the much relaxed impact of the initial tariff reduction.\footnote{Note that several authors such as Naya and Imada, 1992, Albuuro, 1994, Pangestu, 1994, and Chia, 1994 (in Cuyvers and Pupphavesa, 1996, p. 10) argue that the transition period in AFTA is too long, and it has to be speeded up. Moreover, Baldwin, 2006 (in Lendle, 2007, p. 9) presents empirical evidence on tariff underutilization in AFTA.} Second,
the general phase-out program was set out almost identically, but the range of products included was much larger in NAFTA than in AFTA,\footnote{In fact, as Shimizu (2007, p. 76) points out, “the efficacy of AFTA could not be overestimated”. Because, large important sectors were excluded from liberalization, and the regional trade applied by AFTA and the CEPT was extremely small.} and the broader the liberalization, the riskier it can be for the DC, because some weak, yet fundamental sectors might need initial protection to not be crowded out by the foreign stronger competition. Therefore, the AFTA more cautious approach to this issue can allow more flexibility to select the sectors ready for liberalization.

3.2.2. Rules of Origin

Because of their discriminatory nature, PTAs must distinguish non-member-originating from member-originating products in order for a product to be granted preferential access. There are two main features of RoO that would likely play a detrimental role in the level of market access obtained by DCs from a PTA: i) they are costly and complex to comply with, and ii) according to an increasing literature in many PTAs the RoO adopted are protectionist and discriminatory (see below).

First, given the fact that a large part of exporters from DCs are Small-Medium-Enterprises (SMEs), the general restructuring costs generated by trade liberalization can be considerably large, and oftentimes these costs go beyond their capacities. In addition to that, in order for exporters of DCs to take full advantage of the new export opportunities, sometimes they have to totally redesign their administrative practices to produce the required documentation to comply with the complex RoO. Large exporters might be able to internally adopt and implement new software and accounting systems,
but smaller exporters usually have to outsource the exporting practices (Stiglitz and Charlton, 2005). In both cases, the cost can well offset a great part of the benefits obtained from the preferential tariff rate because the total administrative costs imposed by the RoO are high due to the obligation of certifications almost always involving both public and private spheres.\footnote{Some rough estimates suggest that costs of documentation of origin requirements vary between 1.4\% and 5.4\% of the export value (Kume et al., 2006).}

Secondly, and most importantly, RoO have been identified by many authors to embrace hidden protectionism.\footnote{See for example, Krishna and Kruger, 1995 (in Estevadeordal, 1999, p. 6).} RoO, restrictive beyond a certain point in a PTA, have two negative effects: i) they potentially invite members to indirectly protect certain weak domestic industries from direct competition from the partner’s more efficient firms, and ii) they have been found to have trade diverting effects in many potentially trade creating sectors, which is welfare decreasing from a Viner’s perspective (Chapter II, p. 19).

NAFTA is composed of the largest and most restrictive set of RoO today, which, according to many authors, including Hufbauer and Schott (2005), Estevadeordal (1999), Panagariya (1998), Ramirez (2003), Kume et. al. (2006), and Cadot et. al. (2005) are protectionist, trade diverting, and far beyond the necessary in a PTA. Indeed, they have been identified as one of the main causes for the insignificant market access that Mexico has obtained from NAFTA in some of its most competitive manufacturing sectors, like textiles and apparel (see next section).

In contrast, the RoO embraced in AFTA have not been very controversial because they are quite simple and straightforward and based mainly on a regional value content (RVC), which has been set at 40\% according to the “ASEAN content requirement”
ASEAN origin can be simply obtained and enjoy preferential treatment among the members if 40% of the value of a product originated in ASEAN countries and the product is included in the CEPT list. Cuyvers and Pupphavesa (1996) point out that some critics argue that AFTA’s RoO are not in accord with international standards, which might enable abuses and lead to confusing situations. Mainly, there are concerns that third countries might penetrate the regional market using the free-tariff ports of Singapore and Brunei enjoying preferential access to the rest of the area. However, it has not been a topic of much concern since some evidence has discharged such fears (ibid).

There are two concrete differences between the RoO in NAFTA and AFTA that have impacted Mexico and the ASEAN-10 differently. First, the simplicity of complying with AFTA’s RoO in comparison to NAFTA’s might have been less burdensome for AFTA members, allowing them to net larger gains from trade. Second, the lost market access opportunities for AFTA members were likely less than they were for Mexico, due to the restrictive and protectionist RoO in NAFTA.

3.2.3. Other Features

In addition to the two abovementioned characteristics regulating market access in PTAs, there are some other important features that will directly influence a PTA’s final developmental impact and that are certainly related to the market access issues discussed in this chapter. These include reciprocity, government procurement liberalization, and the built-in flexibility embraced in the accord favoring the weaker members.

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68 For text copies of RoO and RVC regulation in ASEAN, go to: [http://www.aseansec.org/17281.htm](http://www.aseansec.org/17281.htm).
First, in order to comply with the GATT Art. XXIV, most PTAs today embrace the concept of reciprocity. However, as Stiglitz and Charlton (2005) recall, PTAs could be relatively more development-friendly if some advantages are provided to the weaker members on “non-reciprocal” basis, especially in PTAs where there are large asymmetries among members (N-S PTAs). For example, if NAFTA were to intrinsically embrace any development drive, it would have been designed differently. As UNCTAD (2007b) points out, Mexico was expected, or forced, to perform from a much less advantageous position on a reciprocal basis with the US and Canada. On the other hand, AFTA is also based on reciprocity, but given the similar stage of development among members, this would likely have had a smaller impact for any individual member. Besides, smaller AFTA members were given more freedom and flexibility to adopt as opposed to the larger initial members (i.e. tariffs, p. 45).

Secondly, one particular aspect of market access in current PTAs is the inclusion of government procurement into the liberalization schedule. This, as Stiglitz and Charlton (2005) report, can have serious development implications given the fact that this sector in DCs on average accounts for as much as 20% of their GDP. Hence, offering this demand to local producers can be a significant policy tool that favors weak domestic producers and achieves a better balance in the economic weight of various social groups and communities within the nation. On the contrary, if this area is liberalized, the government gives up very important policy space to pursue its development goals, as was the case when Mexico signed NAFTA in which is included the liberalization of this area.

In contrast, AFTA does not include the liberalization of this area. Of course, one could argue that Mexican firms have the possibility to bid in US and Canada tender
markets, which are much larger than that of Mexico. However, as UNCTAD (2007b) explains, it is very unlikely that a net benefit from market access for government procurement will accrue for Mexico, because most Mexican producers lack the supply capacity needed for the types of goods and services provided under an average government contract. There is a very important point that needs to be made here. Although market access can be granted in paper by signing a PTA, it is not to be assumed that such market access will be actually exploited by the DC.

Thirdly, one of the most crucial and evident differences between NAFTA and AFTA, not only in regards to market access, but in all the areas covered in the agreements, is the built-in flexibility that AFTA has had since its formation compared with that of NAFTA. On the one hand, the signing of NAFTA arose in a sudden and rushed decision by the Mexican government as it became convinced that profound integration into the world economy was the only ticket to national development and that the US was the ideal, if not the only, partner to achieve this. Hence, Mexico sought to “lock-in” trade preferences and economic reforms by committing itself to NAFTA. But as Panagariya (1998, p. 22) points out, “if these preferences were harmful to Mexico in the first place, the lock is not a benefit but a cost”. Moreover, as UNCTAD (2007b) points out, NAFTA was never set out to eventually further “integrate”, and it might be extremely hard to be renegotiated, at least in favor of Mexican development needs.

On the other hand, AFTA comes from, at least, a longer political cooperation between members. The first attempt to form a PTA was done in 1977. This was

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69 Data from the US Federal Procurement Data System (USFPDS, 2007) reported in UNCTAD (2007b, p. 60) reports that, in 2005, 94% of payments made by the Federal Government went to companies located in the US, leaving only 6% to all suppliers from the rest of the world.
eventually replaced with AFTA. Cuyvers and Pupphavesa (1996) list many other initiatives by the AFTA members in their attempts to understand and shape each others’ economic needs. These include, the Basic Agreement on ASEAN Industrial Projects (AIP), the Basic Agreement on ASEAN Industrial Complementation (AIC), and the Basic Agreement on ASEAN Industrial Joint Ventures (AIJV). These agreements mostly failed or were dismissed to make way for AFTA and the CEPT, but the experience obtained was invaluable. Moreover, AFTA itself has been revisited and revised many times according to the changing needs of the members. The phase-out periods have been pushed forward, more products have been added for liberalization, and at the same time, many countries have fallen behind the initial commitments due national development needs. In addition, unlike NAFTA, ASEAN/AFTA has ambitions to further “integrate” and become ultimately an ASEAN Economic Community (AEC).

3.3. Actual Market Access Outcomes

The previous two sections analyzed how certain pre-existent circumstances might \textit{a priori} determine the level of market access that DCs might obtain from a PTA and the actual accord’s text that those conditions generated in the case of NAFTA and AFTA. In this section, I will present some of the actual outcomes that NAFTA and AFTA have delivered to Mexico and the ASEAN-10 respectively in regards to market access during the lifetime of the agreements.

\textsuperscript{70} As stated on the “Declaration of ASEAN Concord II”, an ASEAN Economic Community is the realization of the end-goal of economic integration as outlined on the ASEAN Vision 2020 to create a stable, prosperous, and highly competitive ASEAN economic region in which there is a free flow of goods, services, investments, and a freer flow of capital, equitable economic development, and reduced poverty and socioeconomic disparities by the year 2020 (ASEAN Secretariat, 2003). See Shimizu (2007) for a more detailed discussion of the integration evolvements in ASEAN.
As mentioned, development is the main objective for DCs in their pursuit of a certain PTA, development that is to make existing sectors more competitive, to acquire new endowments, and to improve employment opportunities and living standards. This can be obtained by expanding the market for their competitive sectors and absorbing and implementing new technologies and production practices during the integration process. However, given their initial capabilities, this process implies the initial concentration on unskilled-labor-intensive sectors such as, low-technology-manufactures, agriculture, and labor-intensive services. Eventually, these sectors should be upgraded and new industries developed as proof of progressive development. Otherwise, the development drive of a PTA might be questioned.

3.3.1. Market Access in Manufactures

Historically, almost the entire manufacturing sector has been controlled by industrialized countries; however, the world market share for DCs has been steadily and rapidly increasing, which reflects the importance of these sectors for DCs as well as the necessity to further increase market access in this area.

As shown in figures III.1 and III.2, Mexico’s total export-flows have increased since NAFTA took effect, especially to the US, which went from 62% of total exports during the ‘80s to 86% during the five-year period between 2001-2006 (UNCTAD, 2007b, p.70). Although increased export-flows are an economic positive according to trade theory, it is also important to note that NAFTA has only increased Mexico’s

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71 According to UNCTAD (2006a), the world’s share of exported manufactured goods for DCs has changed from 24.3% in 1995 to 35.1% in 2005.
dependency on US markets, and hence, its economic performance to become largely subject to the rules of NAFTA (Ramirez, 2003). A great part of this increase occurred in manufactures such as textiles and apparel, automobiles and automobile parts, and electrical and electronic goods. The share of these manufactures in total exports went from around 30% in the early ‘80s to around 80% in 2006 (UNCTAD, 2007b). Nonetheless, as previously mentioned, increased export/trade-flows do not necessarily imply improved market access for the sectors that can positively influence the economic development of the DC, as I will discuss below.

In regards to the textile and apparel industries, the restrictive RoO in NAFTA came to play a crucial role on the final market access that Mexico would have obtained from these sectors. Due to the fact that these industries are considered extremely “sensitive” for the US, the American textile industry pursued a curious and successful strategy regarding its survival by introducing the “yarn-forward-rule” in NAFTA, as reported by Destler (in Kume et. al., 2006, p. 10), which forced Mexican producers to source raw materials from US producers. The textile and apparel sectors in NAFTA have been identified by some authors (Estevadeordal, 1999, and Kume et. al., 2006) as having the most restrictive RoO in NAFTA. These sectors, which had a large potential to generate trade creation due to the high level of protection from all parties, ultimately ended up being one of the few industries in which NAFTA has fostered trade diversion.

Cadot et. al. (2005) have empirically estimated that the apparent market access obtained by Mexico in these sectors has, in reality, been largely offset by the costs incurred by Mexican producers in adjusting to the new sourcing rules implemented by NAFTA. Hence, although trade flows increased in these industries, not only did Mexico
hardly obtain any potential dynamic development benefits from these trade flows, but it might even netted welfare losses due to trade diversion.

The impressive performance of the automotive sectors is oftentimes referred to as novel proof of NAFTA’s success for Mexico. However, there are two main issues that have potentially offset said benefits for Mexico. First, in NAFTA, the auto sectors have the highest RVC, set at 62.5%, which has highly reduced the possibilities of Mexican manufactures to source from cheaper suppliers. This again generates trade diversion (Kume et al. 2006). Secondly, the automotive industry in Mexico is mostly concentrated on the assembly-line process, or the so-called maquiladora programs, which represent on average 45% of the total Mexican exports and 52% of manufactured exports, out of which 20% are from the auto industry. However, maquiladora industries are confined to labor-intensive assembly type activities with mere 3% domestic inputs. Although their contribution to Mexican GDP and employment has grown from 2% and 1.4% in 1993 to 6% and 3.4% in 1999, they remain a highly disarticulated sector from the rest of the economy and highly dependant and susceptible to the dynamism of industrial production in the US (Ramirez, 2003).

Such enclave sectors automatically reduce the developmental impact of some potential dynamic gains from economic integration (Chapter II, p. 28). For example, backward and forward linkages with domestic producers, which in turn could increase economic activity and employment. While technology transfers might take place “within” the sector, its diffusion to the rest of the economy is prohibited (Saggi, 2002).

72 As mentioned by Delgado-Wise (2004), Mexico’s export “miracle” can be largely explained by globalization strategies drawn up in Detroit – the U.S. auto industry accounted for approximately one out of every five dollars of Mexico’s non-oil exports during 1997.
In a fashion like NAFTA, AFTA has also significantly increased intra and extra export/trade-flows (figures III.1 and III.2). However, unlike Mexico that is heavily dependant on US markets, most AFTA countries, with the exception of Laos and Myanmar,\(^\text{73}\) have a much more diversified export-destination-structure (figure III.3). This significantly reduces the dependency on only one external market and, hence, the risks of external economic slowdowns.

**Figure III.3: Major Markets of ASEAN’s Exports, 2004**

![Figure III.3: Major Markets of ASEAN’s Exports, 2004](image)

Source: ASEAN Secretariat, ASEAN Statistical Yearbook (2005).

Like Mexico, one of the most dynamic export sectors for AFTA members is manufacturing, which all together account for 57% of total exports (ASEAN Secretariat, 2005). But unlike Mexican manufactures that contained a mere 1-3% of local inputs, manufactures from the AFTA area on average employ up to 33% of local inputs (UNCTAD, 2006d, p. 187). The sharp increase of intra-regional trade in these areas is mainly due to the successful implementation of the CEPT scheme, which included all manufacturing products in its liberalization schedules. Currently, about 81% of ASEAN’s tariff lines are in the inclusion list of the CEPT, a great part of which are manufactures. AFTA has made it possible to increase trade flows for many reasons, but

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\(^{73}\) Myanmar and Laos destine about 80% of their exports to the AFTA area (ASEAN Secretariat, 2006).
certainly a clear reason is the fact that intra-AFTA tariff rates have dropped from 12.76% in 1993 to approximately 2.7% in 2003 (ASEAN Secretariat, 2006).

Proportionally, AFTA has generated less export/trade-flows than NAFTA did for Mexico. However, these exports appear to have had a generally overall positive impact on all members, simply because the rules of the game were different and more favorable in AFTA than in NAFTA. There are three main differences worth mentioning that might shed some light on this statement.

First, RoO were by far more relaxed in AFTA than in NAFTA, allowing members not only to spend less to comply with them, but also to actually obtain some market access to each other’s markets. Secondly, although AFTA trade flows are concentrated in very specific sectors, they are not as evidently concentrated on the same geographical region as the maquiladora plants in northern Mexico, which has created a dual economy in Mexico, the domestic and the export economy. Thirdly, AFTA has much more built-in flexibility than NAFTA, a very important feature especially for DCs. For example, in AFTA, countries were free to choose what goods to include and when to liberalize them throughout the ten-year period. Mexico had this option for very few sectors. AFTA also includes a “Temporary Exclusion List”, which allows members to temporarily exclude strategic industries from liberalization even if they were initially included. This is permissible under a Protocol Regarding the implementation of the CEPT Scheme Temporary Exclusion List. Malaysia invoked this protocol in 2000, delaying tariff reductions on completely-built-up automobiles, and automobile knock-out kits, in order to protect its local auto industry (US-ASEAN Business Council, 2008). NAFTA has nothing similar to this protocol in its market access clauses.
3.3.2. Market Access in Agriculture

Liberalizing the agricultural sector in DCs can be a very tricky maneuver because on one hand, it is important to expand markets for domestic producers, but on the other hand, local consumers could potentially face extremely high prices due to the inefficient domestic markets. Agricultural reforms, especially in regards to trade liberalization, must proceed carefully, for agriculture represents a very important part of both national development and daily livelihoods in most DCs. The agricultural sector in many DCs represents almost 40% of their GDP, 35% of their total exports, and most importantly, over half of their total employment (Stiglitz and Charlton, 2005) (figure III.4).

**Figure III.4: Employment in the Agricultural Sector**

![Employment in Agriculture as % of Total Employment in Developed and Developing Countries](image)

Source: Author’s calculations from UNCTAD (2006a).

Therefore, DCs with such a high level of dependency in this sector can not afford to opt to offer lower prices to domestic consumers, who mostly live in better off urban areas, at the expense of the large rural population that depends on the local agriculture for survival. It is especially because the low level of support that DCs can offer the sector to increase its production efficiency and capacity to compete internationally. For example, Arroyo Picard et. al. (2003) report that in average industrialized countries spent in 1998 between US$15,000 to US$20,000 per full-time farmer, as opposed to around US$1,000 in the few DCs that do provide agriculture assistance. Moreover, it has to be considered the inefficient labor mobility and nonexistent safety nets that most DCs offer displaced workers (Chapter II, p. 16/37).

74 For example, Arroyo Picard et. al. (2003) report that in average industrialized countries spent in 1998 between US$15,000 to US$20,000 per full-time farmer, as opposed to around US$1,000 in the few DCs that do provide agriculture assistance.
Needless to say, Mexico opted for lower consumer prices in agricultural products with the potential displacement of nearly 8 million farmers, approximately 22% of the economically active population, that depended on the agricultural sector for mere survival before NAFTA (Ramirez, 2003). This is perhaps the most evident and politically sensitive outcome of NAFTA, the near extermination of the agricultural sector in Mexico due to the tremendous import-wave of highly-subsidized agricultural products from the US after NAFTA’s implementation.\(^7\)

The well-known large support of US farmers was expected to have this impact against the merely subsistence farmers in Mexico. Thus, some necessary measures were taken in NAFTA in order to help Mexico to adjust its agrarian economy, allowing a 15 years phase-out period for most of the agricultural sector. However, as reported by Ramirez (2003), 30 months within the accord, the Mexican government decided to liberalize the entire sector and stop any financial support. As a result, imports of corn from the US more than tripled and other commodities such as soybean, wheat, poultry, and beef rose by over 500%, thereby displacing local production. The prices of these commodities dropped in Mexico by about 48% and more than 2 million farmers were displaced and forced to migrate to urban areas or to the US (ibid). In short, recalling Chapter II, by liberalizing agriculture, Mexico has sent the sector from low-productivity to zero productivity – unemployment of farmers.

In contrast, with the exception of Singapore and Brunei, most of the AFTA members also share some of the characteristic of Mexico in the agricultural, such as high

\(^7\) In some accounts US subsidies amount to 37% of the value of total agricultural output (United States Congressional Budget Office, 2006) (reported in UNCTAD, 2007b, p. 68).
export dependency and high employment in the sector. However, there are two crucial differences that are worth mentioning between NAFTA and AFTA that have likely produced the devastating results for Mexico but almost insignificant results on the agricultural sectors of the AFTA members: 1) there are no members in AFTA that have nearly as highly subsidized agricultural sectors as the US does, so the production efficiency and prices were similar in all the members, and 2) AFTA did not liberalize the agricultural sectors nearly as much as Mexico did in NAFTA. Cuyvers and Pupphavesa (1996) report that, initially, only processed agricultural products were included in CEPT schedule, which broaden the scope years later to further liberalize other agricultural products. Moreover, the CEPT reserves a “Sensitive Agricultural Products List” that allows for strategically sensitive products to be excluded indefinitely, if the country chooses to do so. It seems evident that AFTA members opted for the protection of the rural population, which depended on agriculture for survival, rather than securing low prices for the better off urban population as it was the case of Mexico under NAFTA.

3.3.3. Market Access in Services

Although the world’s share of DCs in services trade has steadily increased during the last fifteen years, it is still a sector largely governed by developed countries. Services are oftentimes a large part of DCs’ total GDP. Therefore, increasing market access for these sectors can be very important for development. Moreover, Brown, Deardorff and Stern (in Stiglitz and Charlton, 2005, p. 52) stress the fact that, since

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76 On average the ASEAN-10 employ 48.1% of their population in agriculture (ASEAN Secretariat, 2006).

77 DCs world’s share in traded services has gone from 18% in 1990 to 24% in 2006 (UNCTAD, 2006a).
barriers are typically higher in the service sectors, welfare gains from further world and/or regional liberalization could deliver much larger gains than liberalization in both agriculture and manufacturing.

However, both NAFTA and AFTA are reciprocal agreements, which means that equal concessions have to be given to the trading partners. As Khor (2007) stresses, it is crucial to have a tactical national service plan to understand what services to liberalize, and which not to liberalize, if the sector is to have an overall positive impact. Moreover, as discuss in Chapter II (p. 36) and reported by UNCTAD reports (in Khor, 2007), many DCs lack the supply capacity to respond to service trade opportunities, such as capable human resources, adequate technology, wide telecommunications networks, and overall government support for service firms. Furthermore, UNCTAD notes that DCs, trying to export services to developed countries, face difficult barriers such as lack of commitments on movement of natural persons, due among others reasons, to strict and discretionary visa and licensing requirements and the recognition of qualifications.

Evaluating the impact of services liberalization is more complex than evaluating market access for goods because services trade data are less comprehensive than those of merchandise. A comprehensive discussion on what impact improved market access in services could potentially have on development is beyond the scope of this research. Rather, I will focus on exploring some of the most crucial clauses and liberalization processes that have occurred in NAFTA and AFTA. Specifically, I will point out some of the main differences between both accords and the likely impact that their design might have on spurring or hindering the development process of the DCs involved.
Hufbauer and Schott (2005)\textsuperscript{78} point out that the general impact of trade in services in NAFTA was noticeably smaller than merchandise trade flows for the three members, not only for Mexico. But thanks to one peculiar clause embraced in NAFTA, the small trade in services that took place has permanently harmed Mexico’s domestic economy. NAFTA, like many other US accords, takes the “negative-list-approach” (Chapter IV, p. 75) to services liberalization, which means that all services are included in the liberalization, except the ones that are specifically excluded. Also, UNCTAD (2007b) recalls that there is no possible backtrack.

In NAFTA, there are three evident samples of miscalculations of Mexico’s service liberalization that have had a permanent negative impact. One was a miscalculation from the Mexican negotiators. Another was a flat out violation by the US. The final one should have been included, but it was not.

NAFTA includes provisions for the liberalization of financial services.\textsuperscript{79} Hufbauer and Schott (2005) report that, initially, Mexico had negotiated a long phase-in period, but chose to accelerate the pace of liberalization on the wake of the peso crisis. This resulted in an almost complete take over of the domestic banking sector by foreign banks, which might control the sector according to their own interests and not in favor of Mexico’s development priorities. The foreign share of Mexican banking assets has increased from 1% in 1994 to 90% in 2001. The main consequence of this financial transformation is a drastic reduction of “connected-lending” motivated by political and family relations rather than by sound commercial principles (ibid).

\textsuperscript{78} Also see, Sen, 2003 (in Lesher and Miroudot, 2005, p. 331).

\textsuperscript{79} Chapter Fourteen of the NAFTA text: \url{http://www.sice.oas.org/trade/nafta/naftatce.asp}
Once again, as already mentioned in Chapter II (p. 36), one of the main problems as to why DCs do not fully exploit the market access opportunities that PTAs offer is the supply capacity constraints that they face. The supply of adequate transportation services is a big step forward in overcoming some of these constraints. NAFTA was intended to gradually allow Mexican trucks to operate in the entire US territory, and vice versa. This would have played a tremendous role on the supply capacity of Mexican producers by enabling them to serve the new enlarged market. Indeed, political foot-dragging and judicial challenges indefinitely delayed the implementation of this provision. In fact, up to date the issue is still pending (Hufbauer and Schott, 2005).

The immigration issue between Mexico and the US has a long history before NAFTA. Mexico’s scarce social safety nets are not a product of NAFTA. Traditional trade theory clearly points out the fact that trade will undeniably create winners and losers. Given the fact that Mexico has virtually accepted every demand placed upon by the US on NAFTA negotiations (large provision on free movement of goods and capital) as quoted earlier, at least, some provisions on cross-border movement of unskilled workers should have been one of Mexico’s top negotiating priorities. Unfortunately it was not! That topic was too “hot” to handle in trade negotiations was the official response of all the governments involved (Delgado-Wise, 2004).

Abundant unskilled labor force is one of the main factor endowment differences between Mexico and its two developed partners. The efficient allocation of this resource throughout the region could not have brought anything but benefits to the trading bloc. Instead, some provisions for the cross-border movement of skilled workers were included with very restrictive regulations that have had almost a null impact even for skilled
workers. The only outcome of this neglected priority was the further increase of illegal immigration of displaced Mexican farmers to the US and the further brain-drainage of the already scarce Mexican skilled labor force. Again, as I continue to argue in this thesis, the development drive of current PTAs is not determined by theory, but by the outcomes of the negotiations.

In a similar fashion, AFTA has not been much more successful than NAFTA in creating market access opportunities for its members in the services sectors. This is quite unfortunate since many AFTA economies, such as the economy of Singapore (60% of its GDP), are heavily dependant on services. The rest all have in average from 40% to 50% of their GDP in these sectors (ASEAN Secretariat, 2006). However, unlike NAFTA, if AFTA has not created any real opportunities in this sector, at least it has not delivered any negative results as in the case of Mexico. This has to do mainly with the modus operandi AFTA adopted to regulate trade in services.

Basically, AFTA’s regulation of services is based on GATS regulations with some “Plus” provisions, which means it operates under the positive list approach. Services liberalization in AFTA has made some slow, but substantial progress on a “request-offer-approach” basis. According to ASEAN Secretariat (2007a), five packages of liberalization have been passed, which comprise important services industries, such as

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80 NAFTA provides for the so-called TN Visa allowing skilled Mexican workers to enter the US for temporary work. The annual cap was placed at 5,500 for Mexican workers, but was left unlimited for Canadian workers (Hufbauer and Schott, 2005).

81 Calculations in Hufbauer and Schott (2005) state that, the number of Mexican emigrants to the US has more than double in the period of 1991-2000 going from an annual average flow of 165,584 yearly emigrants to 224,942.

82 In a positive list approach “all” sectors are excluded from liberalization, only the ones listed for inclusion get liberalized (UNCTAD, 2006c).
tourism, telecommunications, maritime-transport, financial services, construction, air-transport, distribution, business services, and education. Moreover, unlike NAFTA, the liberalization and harmonization of services in some crucial areas, such as land transport and professional licenses recognition, has made some substantial progress. For example, agreements have been made to recognize in all member countries professional licenses to facilitate the free movement of service providers in the areas of engineering and nursing. Also, an agreement is being negotiated to facilitate land transport across borders (ASEAN Secretariat, 2007a).

Without a doubt the impact of liberalization in services in NAFTA and AFTA has been different. On one hand, the liberalization of services not only brought zero benefits to Mexico as far as increasing market access and spurring its economic development, but in some instances this liberalization was harmful. This was mainly due to the negative list approach that NAFTA embraced and to the supply capacity constraints of Mexico in this sector. The consequences are that Mexico completely rendered its domestic banking sector to foreign capital and it has missed out the opportunity to efficiently allocate its most abundant factor endowment (labor), generating an ever-increasing emigration flow to its northern partners (mainly the US). AFTA members, on the other hand, have not made much progress on benefiting from the potential of liberalizing trade in services, but they certainly have progressively approached the matter in a strategically beneficial fashion, and at least, AFTA has not have had any significant negative results.

With this, in the next chapter, I strive to explore the potential developmental gains that foreign investment have, or could have, delivered to Mexico and to the ASEAN-10, mainly based on the discussion presented in Chapter II.
CHAPTER IV: FOREIGN INVESTMENT IN NAFTA AND ASEAN

Once again, I would like to recall the discussion in Chapter II, where it was recognized that foreign investment (mainly in the form of FDI) has the noticeable potential, at least in theory, of delivering various dynamic developmental benefits to the host economy. However, it was also emphasized that the “amount” of developmental benefits created was largely determined by the “quality”, rather than the “quantity”, of such investments, which in turn will be subject to the factors that attracted them in the first place (strategy). Most importantly, it was stressed that the realization of such benefits mostly depends on the host economy’s absorbing capacities and the proactive role of the government to shape the outcome.

According to UNCTAD-World Investment Report (2006d), global inflows of foreign investments have marked a third consecutive year of growth in 2006, raising to US$1.3 trillion and almost reaching the record level of US$1.4 trillion achieved in 2000. However, the lion’s share is still directed to industrialized countries, which attracted 66% of it. Although the share of DCs has also increased, they are still lagging behind.

There are many factors, mainly domestic policies and capabilities, that have been proven efficient in attracting foreign investments, as discussed in Chapter II. However, getting these factors synchronized and improving the country’s attractiveness for foreign investments is not a simple task to achieve, especially for DCs. Instead, during the last

83 See for example, UNCATD (1999); Miyamoto (2003); and Plummer and Cheong (2008); and Lall and Narula (2004) for a more extensive discussion on FDI determinants.
decade or so, entering International Investment Agreements (IIAs) has gained in popularity among DCs in efforts to attract foreign investors (UNCTAD, 2006b). These agreements, which oftentimes function as a sort “investment-insurance-policy”, alleviating foreign investor’s concerns in regards to DCs’ economic, political, and legal reliability, are pursued by DCs in hope of increasing their credibility as attractive destinations for foreign investments.

The efficiency of IIAs as foreign investment magnets is a matter of current disputes, as previously mentioned, and further discussing the issue is beyond my scope here. However, it is important to stress the fact that their rapid proliferation is of serious concern, for it could potentially trigger a race-to-the-bottom effect putting at risk national development strategies (Stiglitz and Charlton, 2005). Moreover, UNCTAD (2006c) warns of the fact that commitments in these agreements significantly reduce the policy-space flexibility available to domestic governments in meeting their development goals. This negative consequence of IIAs is oftentimes neglected by DCs, that try to offer the best investor-concessions in order to attract them, overlooking the fact that this could well offset many of the benefits of foreign investments, since these concessions stipulate foreign investors’ rights, but hardly ever address their obligations.

This chapter evaluates and compares the effects that the formation of AFTA and the ASEAN Investment Area (AIA) have had on foreign investment patterns in the

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84 For further discussion, see for example, Plummer and Cheong (2008) and Lesher and Miroudot (2005).

85 According to UNCTAD (2007a), in 2006 there were more than 2,500 BITs, and 240 PTAs that included investment provisions. Moreover, UNCTAD (in Stiglitz and Charlton, 2005, p. 150) reports that DCs are quite active in entering IIA at all levels, accounting for 42% of total new BITs in 2001.

86 AIA was formed in October of 1998 by the ASEAN member countries (at the time) to promote intra-foreign investment inflows (see below), for more detail go to: http://www.aseansec.org/6462.htm .
ASEAN-10 and the effects that the inclusion of investment provisions in NAFTA has had on Mexico’s foreign investment. An analysis and comparison of the commitments and concessions in each respective agreement will allow me to assess the strategy’s efficiency in attracting more and better foreign investments and also to determine the amount of potential development benefits that could have been created from the quantity and quality of such investments, notwithstanding the fact that the ultimate realization of those benefits will depend on the DC itself.

The first section, mainly based on UNCTAD (2006b), summarizes some of the most important characteristics in IIAs in order to offer a general understanding of the developmental implications of these schemes, reflecting the price that DCs (in this case Mexico and the ASEAN-10) have to pay in order to attract foreign investment. The second section thoroughly reviews how Mexico and the ASEAN-10 sought to attract foreign investment under their respective accords (strategy), how much foreign investment (quantity) these strategies attracted, and finally what type of foreign investment was attracted and to what sectors (quality). This analysis should contribute to the overall assessment of the developmental impact that foreign investment has had on Mexico and the ASEAN-10 during their respective accords.

4.1. Common Characteristics of IIAs

According to UNCTAD (2006b), there is long list of clauses and characteristics that most current IIAs include and which regulate the flow of foreign investment between home and host economies. From a development perspective, they function as the determinants of the final impact and direction that foreign investment inflows will have
or take once the agreement has been signed. It is also important to note that most IIAs do not include backtrack clauses in the case of miscalculation and/or underutilization of the clauses. These specific features of IIAs can be an efficient tool that can be used to attract foreign investment by “locking-in” favorable concessions for international investors. At the same time, they oftentimes go against the developmental strategies of many DCs, as already motioned. Following is a list of some of the most important characteristics that might have a direct impact on the development benefits that increased inward FDI could or would have on the host economy.87

A). The Negative-List-Approach: As explained by UNCTAD (2006c), this approach to investment treaties offers many opportunities because it tactically allows negotiators to pick and choose what sectors to liberalize to foreign investment and under what conditions. At the same time, it requires a far more sophisticated set of negotiating skills, administrative resources, and information available, if it is to be utilized positively. However, in the case of DCs, it could be a disadvantage since they traditionally lack all of the above. Hence, there could be potential misutilization of the scope of the agreement on the exceptions that need to be made in crucial sectors for development (see Lesher and Miroudot, 2005 for further discussion).

Therefore, a positive list approach could be better managed by DCs when entering IIAs, especially with developed partners that possess far reaching capabilities (N-S PTAs). Unfortunately for Mexico, NAFTA’s investment provisions embrace the negative list approach as opposed to AIA that embraces the positive list approach.

87 See UNCTAD (2006b) for full list of IIAs features.
B). Expropriation Clauses: A justifiable major impetus in the negotiation of IIAs is to obtain protection for foreign investments against expropriation by the host country, which is widely accepted in customary international law.\(^{88}\) However, the drawback of this clause in IIAs is not concerned with “direct” expropriation, but rather, with the interpretation of “indirect” expropriation, which is included in some IIAs like NAFTA’s Art. 1110.\(^{89}\) This is quite dangerous since it can be abused by TNCs against local governments, which in turn hesitate to pass any change of laws regarding the directing of such investments in line with domestic development projects in areas such as the environment and health (Arroyo Picard et. al., 2003).

A broad interpretation of “indirect” expropriation further guarantees foreign investors protection but hardly addresses their obligations. Indeed, NAFTA’s Art. 1110 and its broad interpretation of “indirect” expropriation has generated a very significant number of investors-state disputes between investors and governments in the NAFTA countries. A report issued by Public Citizen in 2005 reports 42 cases of claims filed against all three NAFTA parties by foreign investors with a total worth of US$28 billion. The Mexican government has been the most affected of the three NAFTA governments, with a total of 43% of the claims against, or 18 cases worth almost 50% of the total awards to investors, US$16.5 billion out of a US$35 billion total.\(^{90}\) The US has also been sued by foreign investors (mostly Canadian), but according to the same report, the US has


\(^{89}\) For a full description of this article go to: [http://www.sice.oas.org/trade/nafta/chap-111.asp#A1110](http://www.sice.oas.org/trade/nafta/chap-111.asp#A1110).

\(^{90}\) See Public Citizen Report (2005) for further detail on particular cases, awards, and general information on the subject. Also Arroyo Picard et. al. (2003) present a detailed analysis of the implications that these cases have had on Mexico.
not lost a single case. It reflects the importance of a capable legal system available in the host country to face the extensive legal resources that many TNCs possess.

These results have been possible thanks mainly to the general state of the art dispute settlement mechanism embraced by NAFTA and, specifically, to the arbitration consent clause in investor-state disputes (NAFTA’s Art. 1122). These concessions largely reduced the policy space available to the Mexican government to strategically direct inward foreign investments towards its development efforts.

In contrast, ASEAN does not specifically addresses dispute settlement mechanisms in the corpus of AIA. In fact, as reported by Cuyvers and Pupphavesa (1996), it has been the subject of several critics in regards to its loose overall dispute settlement mechanism, which decreases the ASEAN-10’s overall credibility and attractiveness as foreign investment destination. In response to these critics, ASEAN members embraced in 1996 the “Protocol on Dispute Settlement Mechanism”, which was later revisited in 2004 by the “ASEAN Protocol on Enhanced Dispute Settlement Mechanism” (ASEAN Secretariat, 1996).

C). Most-Favored-Nation (MFN) and National Treatment: In short, the MFN and National Treatment clauses in IIAs imply that foreign investors enjoy the same conditions applied to both national investors and/or the conditions, when more favorable, applied to any other foreign investor that is not part of the agreement. This potentially limits the government’s policy space to favor national investors which most of the times

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91 For an original version of this article go to: http://www.sice.oas.org/trade/nafta/chap-112.asp#A1122

92 Go to: http://www.aseansec.org/16654.htm for a detailed version of these agreements.
are already at a disadvantage against TNCs that enjoy the size effect and better access to international capital markets. For this reason, an increasing number of countries involved in IIAs oftentimes delimit this concession only to the MFN omitting national treatment to foreign investors (UNCTAD, 2006b).

Unlike NAFTA that includes both clauses (NAFTA’s Art. 1102-1103 respectively),\(^93\) AIA only includes the MFN clause (Art.8.1),\(^94\) though the members have committed to include the national treatment clause in all the included investing sectors in AIA after 2010 (ASEAN Secretariat, 1998). Moreover, some AIA members, such as Brunei, Indonesia, Malaysia, and Singapore on their individual external IIAs, do not include the national treatment clause and/or do so only in strategically selected sectors in which national investors would not be able to meet the investment requirements needed to promote the development of those sectors (UNCTAD, 2006b). This strategy reflects a proactive involvement of local governments in beneficially directing inward FDI.

**D). Performance Requirements:** This clause is perhaps the most important mechanism that DCs can embrace in IIAs, allowing them to have some sort of strategic direction of FDI towards meeting their development goals. For example, the implementation of performance requirements can help to ensure that FDI contributes to employment, to the overall economic activity in the host economy (creating forward and backward linkages), and to facilitate technology transfers by requiring foreign investors to act in line with the country’s development, and not only on their own interests.

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\(^93\) For original text go to: [http://www.sice.oas.org/trade/nafta/chap-111.asp#A1102](http://www.sice.oas.org/trade/nafta/chap-111.asp#A1102).

\(^94\) For original text go to: [http://www.aseansec.org/7994.pdf](http://www.aseansec.org/7994.pdf).
This clause, however, is incompatible with the national treatment clause, which releases the foreign investor from any requirements that local investors are not subject to. Mexico, obviously, by embracing the MFN and national treatment of foreign investors under NAFTA, has given up the possibility of ensuring that foreign investment projects are favorable to its development process.\(^95\) On the other hand, many ASEAN countries, not having committed to national treatment to foreign investors, have had the opportunity to strategically use this clause to direct inward FDI and to ensure it has a positive impact on the economy. Moreover, some ASEAN schemes such as ASEAN Industrial Cooperation Scheme (AICO),\(^96\) which I discuss in greater detail later, do have specific performance requirements and investor obligations. In fact, most projects entering the ASEAN zone in the manufacturing sector have to be, at least, previously approved by the host economy (see below).

E). Transfer of Funds or “Transfer-Pricing”: Suppose that corporate taxes are higher in the host economy of a certain FDI project than in the home economy. This invites foreign investors to remit their profits to the home country. This situation could have a negative impact on the host economy because, if TNCs are able to extract their profits via intra-company transactions at artificial prices, the benefits of foreign investment to the host economy are accordingly reduced (UNCTAD, 1999). In addition, UNCTAD (2006b) reports that allowing free transfers of funds from foreign investors is

\(^{95}\) NAFTA Art. 1106 prohibits any type of performance requirement as specifically stated on the full text of the article, go to: [http://www.sice.oas.org/trade/nafta/chap-111.asp#A1106](http://www.sice.oas.org/trade/nafta/chap-111.asp#A1106).

\(^{96}\) AICO was agreed upon at the informal ASEAN Economic Ministers Meeting in April 1996 and came into effect in November 1996 in each ASEAN country, go to: [http://www.aseansec.org/6400.htm](http://www.aseansec.org/6400.htm).
of further concern to the host economies, especially when foreign exchange reserves are low. For example, if a foreign investor seeks to transfer a large amount, it further depletes exchange reserves needed for other purposes. Another concern is that, permitting free transfers might result on a massive capital flight during time of economic difficulty, thereby, exacerbating the host country’s problems.

Article 1109 of NAFTA\textsuperscript{97} explicitly allows members to freely transfer funds at any times without restrictions. On the other hand, AIA specifically addresses the issue in article 15\textsuperscript{98} to safeguard the balance of payment, allowing host economies to invoke this article in case of emergencies in regards to the concerns mentioned above.

\textbf{F). Intellectual Property Rights (IPR) Protection:} Although IPR protection is not specifically included as part of IIAs,\textsuperscript{99} it does, however, directly affect the beneficial outcomes from inward FDI, such as the level of technology transfers that can take place among the trading partners. Therefore, it is more than relevant to discuss the issue in this section. The argument regarding adequate protection of IPR and development is extremely complex, and adequately discussing it is beyond the scope of this thesis (see Lall and Albaladejo, 2002). Rather, I will only point out some general implications of IPR protection on development and what has been the approach of NAFTA and ASEAN.

\textsuperscript{97} For original text go to: \url{http://www.sice.oas.org/trade/nafta/chap-111.asp#A1109}.

\textsuperscript{98} For a full text of AIA art. 15 go to: \url{http://www.aseansec.org/7994.pdf}.

\textsuperscript{99} Rather, IPR protection, in most PTAs, is included as a separate part of the agreement as a characteristic of “deep-integration” and “new-regionalism” (Chapter I). IPR protection packages are included in PTAs for different reasons. For example, in N-S PTAs, such as NAFTA, IPR protection packages are accepted by the DC in exchange with other benefits – for example, market access. In S-S PTAs, IPR protection is less important for any member; hence, it usually takes the form of loose side agreements.
The general available literature on IPR protection and development, at best, has generated the typical answer in economics: “it depends”. In this case, whether strong or lax IPR protection has a positive impact on development “depends” on the country’s level of development. This means that an economy at an advanced level of development will benefit from strong IPR protection, and less developed economies will probably benefit from lax IPR protection. For example, lax IPR protection allows DCs to imitate and reverse engineer to upgrade their technological base, after a threshold is passed, strong IPR protection can become beneficial by stimulating new private innovation. This suggests that the forerunners in technological change (industrialized countries) will benefit the most from strong IPR protection.

According to UNCTAD (2006b), there are two main approaches to the adequate protection of IPR in most IIAs. First, negotiating members of the agreement opt for adopting the already existent international standards, such as the WTO Trade-Related Aspects of Intellectual Property Rights (TRIPS). Second, some accords go beyond international standards and opt for creating their own set of IPR regulations.

In the case of ASEAN, IPR protection mainly falls under the first category. ASEAN members have been continuously promoting the importance of IPR protection for the sake of technological and economic advancement, but have not gone far from their TRIPS obligations, and take instead a rather lax approach. The ASEAN-10 mainly regulate IPR protection and promotion through the “ASEAN Framework Agreement on

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100 Lall and Albaladejo (2002, p. 6) identify the turning point to be US$7,750 per capita income in 1985 prices. These authors refer to other studies such as, Chang (2001) and Rasiah (2001) for further detail.

101 Lall and Albaladejo (2002) point out that the creation and diffusion of new knowledge are desirable and beneficial for growth; hence, it is necessary to trade off static optimization in favor of dynamic considerations, inducing private agents to invest in the production of new knowledge.
Intellectual Property Cooperation”, 102 which mainly revolves around the obligations in the TRIPS agreement.

In contrast, NAFTA goes far beyond the regular requirements of TRIPS, adapting its own rules for IPR protection (NAFTA’s Chapter, 17). 103 This has had an extra negative impact on Mexico, not only from extra costs implementing a national set of laws that fit both the TRIPS agreement and NAFTA’s regulations, but it also significantly reduces the potential of benefiting from any technological spillovers due to the strict regulations concerning patents, copyrights, and trademarks from its developed trading partners (Arroyo Picard ed. al., 2003).

4.2. Foreign Investment Evolvements

Mexico and the ASEAN-10 have both opted for the PTA-Formation-Strategy to attract foreign investment as stated in their respective objectives. 104 The overall real efficiency of this strategy in both instances is, however, a matter of dispute. On the one hand, FDI stocks in both instances seem to have been accumulating at a faster pace since the respective accords took place, suggesting that on average inflows have indeed increased (figure IV.1). But on the other hand, some economists 105 argue that the respective accords were not the reason for such increase, but rather that many other factors that were taking place at the same time, such as world investment trends.

102 For a full text version of this agreement go to http://www.aseansec.org/6414.htm.

103 For a full text version of this chapter go to: http://www.sice.oas.org/trade/nafta/naftatec.asp.

104 AIA Art. 3(i) at: http://www.aseansec.org/7994.pdf), and NAFTA Art. 102(c) at: http://www.sice.oas.org/trade/nafta/chap-01.asp#Chap.1.

105 In the case of NAFTA, see for example, Arroyo Picard et. al. (2003) and Ramirez (2003). For the ASEAN schemes, see for example, Plummer and Cheong (2008).
However, this issue of quantity is not of much relevance to the scope of this research. Rather, the quality and direction given to such investments is what counts the most for development, as it has been discussed throughout this thesis and stressed by some economists including Lall and Narula (2004). Moreover, the overall ultimate impact on development will not be determined by the quantity and/or quality of foreign investment, but could be further influenced by the commitments and concessions embraced in each accord as discussed previously, where bargaining power and asymmetries among members, once again, will play a determinant role in drafting a development-friendly accord.

By grouping the main characteristics of each agreement (see the previous section), a clear difference can be observed between NAFTA’s investment provisions and the ASEAN-10 investment schemes. On the one hand, by accepting certain conditions on regulating inward foreign investment under NAFTA, Mexico seems to have adopted a passive and general full liberalization of foreign investment with little or no restrictions at all, thereby relying on market forces to do a government’s job. On the other hand, the ASEAN-10 seem to have taken a more cautious and conservative approach to foreign

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106 Ramirez (2003, p. 874) quotes an ECLAC (2002) report in which is expressed that “…of the 704 (sectors) listed in the Mexican Classification, 606 are fully open to foreign capital, as share of up to 49% is permitted in 35 others, prior authorization from the National Foreign Investment Commission (CNIE) is required in 37, and FDI participation in not allowed in only 16 cases.”
investment liberalization in order to leave some space for the governments to play a proactive role in directing it.

Hence, in this section, it is necessary to analyze the different approaches in order to confirm the above deduction and to access each strategy’s efficiency in attracting more and better foreign investment that would ultimately enhance their development. This can be done by posing simple but essential questions: i) how and how much foreign investment has each strategy attracted?, and ii) what type of foreign investment have they attracted, from whom, and to what sectors?

4.2.1. How and How Much Foreign Investment was Attracted?

One of Mexico’s key objectives in NAFTA was to attract foreign investment, not only from its trade partners, but from the rest of the world, as documented by some authors including Tornell and Esquivel (1997), and it accomplished it.\(^{107}\) It was mainly due to the very favorable conditions offered to investors, especially to US and Canada investors, but also to a lesser extent to extra-NAFTA investors. Mexico’s principal tool in the NAFTA accord to attract foreign investment is Chapter 11,\(^{108}\) which embraces one of the most favorable set of investment conditions that exist today. It embraces a large scope of coverage for sectors to be liberalized (the negative list approach). It includes the MFN and national treatment principle (Art. 1102 and 1103). It guarantees a minimum standard treatment to investors (Art. 1105). It does not include any performance

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\(^{107}\) Waldkirch (2003) and The World Bank (2003) (in Lesher and Miroudot, 2005, p. 32) report a clear positive effect of NAFTA on FDI in Mexico, and suggest that this positive effect has come almost exclusively from raising investment from Canada and the United States, rather than from other countries wishing to access the NAFTA market.

\(^{108}\) For a full text version of Chapter 11 go to: [http://www.sice.oas.org/trade/nafta/naftatce.asp](http://www.sice.oas.org/trade/nafta/naftatce.asp).
requirements (Art. 1106). It includes few exceptions (the most important exception of the accord is the National Oil Industry (PEMEX)).\textsuperscript{109} It allows free transfer of funds (Art. 1109). It includes a direct and indirect expropriation clause (Art.1110). Investors from the NAFTA area enjoy a quite reliable dispute settlement mechanism. And it includes many other investor rights with little mention to their obligations.\textsuperscript{110}

Moreover, as already mentioned, the favorable trends of world’s investment inflows and being one of the largest developing economies has allowed Mexico to increase its foreign investment stock from about US$41 billion in 1995 to US$228 billion in 2006 (figure IV.1). To what extent NAFTA is responsible for this is a matter of large disputes based on two grounds. Firstly, it is argued that NAFTA had not much to do in attracting more foreign investment and that other internal factors and world trends were the main reasons, even though, disentangling one from the other has proven to be a challenging task (Ramirez, 2003). Secondly, it is simply argued by some economists that there was no real increase of inward foreign investment during the period of NAFTA in comparison to previous periods, but that there was an annual average decrease.\textsuperscript{111} The only thing that NAFTA is responsible for is the type of foreign investment that came into Mexico (Arroyo Picard et. al., 2003, p. 42) (see below).

On the other hand, the ASEAN-10 have for a long time been important independent recipients of foreign investment, especially the five founding members

\textsuperscript{109} For a full list of exceptions go to: \url{http://www.sice.oas.org/trade/nafta/anx3mex.asp}.

\textsuperscript{110} See Lesher and Miroudot (2005) for a more detail discussion on NAFTA’s investment provisions.

\textsuperscript{111} Base on data from Mexico’s National Bank, Arroyo Picard et. al. (2003, p. 42) report that yearly average foreign investment inflows to Mexico were higher during the period before NAFTA than during the period of NAFTA, US$16.5 billion and US$15 billion per year in average, respectively.
(Singapore, Malaysia, Indonesia, Thailand, and the Philippines). However, as Cuyvers and Pupphavesa (1996) point out, at the beginning of the ‘90s, the ASEAN economies perceived the threat of investment diversion due to the rise of China and other East and South Asian countries that were perceived as attractive destinations for foreign investors, bypassing many of the advantages that these economies previously enjoyed. Hence, “re-attracting” foreign investment for the founding members and attracting more foreign investments for late comers (Brunei, Cambodia, Laos, Myanmar, and Vietnam) were the key motivations to form AFTA, AIA, and AICO, in order to better compete with other emerging economies in the region. As Plummer and Cheong (2008) state, the intent was to form a “one-stop investment center” with a broader, and more integrated production-base, offering investors the opportunity to reap larger benefits from scale economies, transaction costs reduction, and vertical integration of production.

As Mexico did in NAFTA, the ASEAN-10 intended to attract intra-bloc investments, but for the ASEAN-10, it was more important to attract extra-bloc investments, which are the largest source in the area (figure IV.6). Unlike NAFTA, however, ASEAN members embraced a lesser attractive structure on their respective schemes as far as freedom and concessions to foreign investors (see previous section).

ASEAN members created two main schemes to attract intra and extra-bloc foreign investments, namely AIA and AICO. AIA is the main tool in promoting general investments in all sectors included in the accord, which can be compared to NAFTA’s

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112 Plummer and Cheong (2008, p. 2) report that during the mid-‘90s ASEAN countries accounted for about 8% of world inflows, but dropped to 4% in recent years due to the 1997 Asian Financial Crisis.

113 In the period of 1995-2004, 86.4% of FDI inflows into the ASEAN area were extra-ASEAN compare to only 11.6% of intra-ASEAN FDI inflows (ASEAN Secretariat, 2005) (see figure IV.6).
investment provisions. But unlike NAFTA, this scheme embraces, on the one hand, less friendly concession to foreign investors, but on the other, it leaves more policy space for the respective governments to direct these investments.

In addition, ASEAN members have also formed another scheme (AICO), which is strategically designed to attract foreign investment into the industrial sectors, in hopes of enhancing their technological bases from countries such as Japan, the US, and the EU. AICO is open to any ASEAN-based company meeting the following requirements: 1) the company is incorporated in and operates in an ASEAN country, 2) it included a minimum of 30% ASEAN equity, and 3) the company engages in some form of resource sharing, such as the sharing of technology, market sharing, or consolidated purchase of raw materials. There are two important principles in this scheme. One, it is directed to the industrial sectors, and two, it embraces some sort of performance requirements to maximize the benefits to the ASEAN-zone. Moreover, each ASEAN member has been constantly pursuing individual strategies to improve their economic environment and attract foreign investment (ASEAN Secretariat, 1997).

As reflected in figure IV.1, it appears that, to a certain extent, these schemes and the unilateral initiatives taken have positively influence the ASEAN-10 FDI stock, rising from around US$148 billion in 1995 to US$420 billion yearend 2006. However, some empirical studies suggest that the correlation of the ASEAN schemes has been less evident and more ambiguous than in NAFTA. For example, Jeon and Stone (2000) find that the ASEAN schemes have had an insignificant impact on FDI flows, both intra and

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114 AIA is mostly directed to intra-bloc investment promotion; however, by further harmonizing ASEAN investments as whole, AIA could also be a positive force to attract extra-bloc investment. AIA currently covers five sectors: manufacturing, agriculture, fishery, mining, and quarrying, as well as services incidental to the five sectors (“Service incidental”) (Plummer and Cheong, 2008).
extra-bloc. Nonetheless, Plummer and Cheong (2008) find that AIA, in particular, has had an insignificant impact on extra-bloc FDI flows, but has influenced significantly and positively intra-bloc flows. Moreover, an independent research carried out by the ASEAN Secretariat in April 2007, “Completing the AIA – Road Traveled, Road Ahead”, states that AIA has had an overall positive effect on FDI flows, especially in recent years.

To sum up, despite of the fact that there are many other factors influencing FDI flows and that it is quite difficult to disentangle one from another, it appears that both the ASEAN-schemes and NAFTA’s investment provisions have positively impacted inward FDI flows to Mexico and to the ASEAN-10 (increasing quantity). However, it also seems that NAFTA has had a more evident influence on inward FDI flows than the ASEAN schemes, suggesting that Mexico’s strategy might have paid off better in terms the quantity attracted. However, the costs involved in doing it, in terms of policy reduction, might have also been higher. In other words, Mexico opted for a strategy that will allow it to increase FDI quantity, and the ASEAN-10 opted for a strategy that allows them to regulate FDI flows while increasing the quantity.

4.2.2. What Type of Investments and Where Did They go?

Again, as already mentioned, from a development perspective, what matters the most is quality rather than quantity. Therefore, a better assessment of foreign investment can be done by analyzing its qualitative features and the direction it has taken within the host economy(s) in this case Mexico and the ASEAN-10. There is no “stylized” method to evaluate foreign investment’s “quality”, but an attempt can be made by observing some key factors, such as the type of investment and activity sought by foreign investors,
the countries where those investments come from (developed or developing countries), and the sectors in which these investments were made. It is also important to note that the quality of such investments will be largely determined by the initial local capabilities of the host country, and the proactive involvement of local governments will be essential to give these investments the “right” direction.

A). Portfolio Investments: It was concluded in Chapter II (p. 25) that it is not quite clear how portfolio investments affect the host economy. Moreover, as pointed out by Hufbauer and Schott (2005), these types of investments are harder to calculate because longitudinal data on them is scarce and unreliable. Hence, an adequate discussion on portfolio investments in NAFTA and ASEAN will not be presented here. Nonetheless, there is an important difference between NAFTA and AIA worth mentioning in order to illustrate the potential impact that portfolio investments might have had in both cases.

AIA specifically addresses this issue and prohibits portfolio investments (Art. 2-Coverage).115 Hence, it could have no impact on the ASEAN economies. On the other hand, portfolio investments have been fully liberalized in NAFTA under Chapter 11, guaranteeing the complete freedom of capital movements. This is interesting, since the other factor of production, labor, was entirely restricted.

In addition, NAFTA allows freedom of transfer funds (Art. 1109), which makes this type of foreign investment more irrelevant to the impact that the inflow of foreign capital might have had on Mexico’s development efforts. Instead, portfolio investments might have had a negative impact on Mexico. For example, some economists, including

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Ramirez (2003) and Arroyo Picard et. al. (2003), argue that large capital inflows of so-called “hot-money” during NAFTA’s eve and opening might have worsened, if not directly caused the Mexican “Tequila/Peso Crisis” of 1995 by flooding the Mexican financial system with foreign capital from highly volatile international capital markets.

B). FDI Inflows: In Chapter II (p. 26/34), there were identified four main types of FDI which each offer different positive externalities to the host economy. It was also discussed that, historically, most DCs have mainly attracted efficiency-seeking investments into low-technology manufacturing sectors (UNCTAD, 1999). Partially, this is due to the fact that most DCs are endowed with large unskilled labor surplus, which makes labor cheap and attractive for TNCs. Also, as explained by Lesher and Miroudot (2004), on one hand, the reduction of trade barriers resulting from PTAs reduces market-seeking or “tariff-jumping” investments from firms characterized by high fixed costs, and on the other, this allows efficiency-seeking investments to increase. Indeed, this pattern has taken place in Mexico and in the ASEAN-10 which have mainly attracted efficiency-seeking FDI to their manufacturing sectors – 62.87% during the period of 1994-2000, and 34% in the period of 1999-2004 respectively (figure IV.2).

**Figure IV.2. Inward FDI by Sector in Mexico and the ASEAN-10**

Source: Author’s adaptation from various sources. (Mexico’s figures are from Arroyo Picard et. al. (2003, p. 47) – 1999-2000. The ASEAN-10’s figures are from ASEAN Secretariat (2006) – 1999-2004. Note: the high share of investment in Mexico’s financial services includes a one time large investment of US$12.5 billion due to the City Bank’s purchase of Banamex.)
It was also concluded in Chapter II, that efficiency-seeking investments put at the doorstep of the host economy substantial initial benefits according to the level of development, but a certain absorbing capacity was necessary to capture such benefits. Also, a proactive role of the government was fundamental, not only in order to direct FDI, but most importantly, to retain initial investments by constantly stimulating local capabilities through policies that involve all local economic agents. Thus, this subsection thoroughly analyzes whether or not Mexico and the ASEAN-10 have been able to benefit from the large FDI inflows experienced during their respective accords.

Although there are controversies about the extent to which NAFTA helped Mexico to attract FDI, there is a unanimous consent about the fact that NAFTA has favored a net inflow of FDI as opposed to portfolio investments (table IV.1).

<table>
<thead>
<tr>
<th>Period</th>
<th>Total</th>
<th>Direct Abs</th>
<th>Shares Abs</th>
<th>Total bonds Abs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pre-NAFTA 1989-93</td>
<td>82,787.3</td>
<td>19,352.0</td>
<td>24,319</td>
<td>39,115.8</td>
</tr>
<tr>
<td>NAFTA 94-2000</td>
<td>105,291.0</td>
<td>80,206.7</td>
<td>15,600</td>
<td>10,915.1</td>
</tr>
</tbody>
</table>

Source: Statistics based on the bank of Mexico presented by Arroyo Picard et al. (2003, p. 43)

However, despite this positive feature of NAFTA, many studies suggest that inward FDI has yet to deliver overall positive effects to the Mexican economy. The main reason expressed in these studies has to due with the general passive role of the Mexican government in directing FDI, in part enforced by the rules and regulations of NAFTA’s Chapter 11. This has created two evident enclave FDI destinations (figure IV.3): one, the Federal District (Mexico City), which is by and large historically the most vibrant economic area of the country and to which increased FDI comes without surprise;

\[116\] For example, Hufbauer and Schott (2005); UNCTAD (2007b); Ramirez (2003); and Arroyo Picard et al. (2003) to name just a few.
and two, the northern part of the country, mainly in the maquiladora sectors, which are highly disarticulated from the rest of the economy (Chapter III, p. 61).

**Figure IV.3. Inward FDI flows To Mexico by Area (1994-2000)**

![Chart showing FDI flows to Mexico by area](chart.png)

Source: Adaptation from Arroyo Picard et al. (2003, p. 50)

Notes: 1) Mexico City’s data includes the State of Mexico. 2) 19.35% in the northern states went to the maquiladora sector. 3) some states in the rest of Mexico such as Chiapas, Oaxaca, Guerrero, Hidalgo and Veracruz (all southern states) accounted only for 0.31% of all FDI.

Most of the initial FDI projects in the maquiladora sectors were efficiency-seeking (looking for low-cost labor), which is perfectly normal for DCs according to their actual level of domestic capabilities and endowments. However, in the case of Mexico, the two FDI enclaves have not only hardly generated any benefits like forward and backward linkages and/or technology spillovers for the rest of the economy, but also have largely contributed to the marginalization of other geographical areas and important sectors for development. For example, as reflected in figure IV.3, most rural/agrarian central and southern states have received a mere 0.31% of total. The agricultural sector have received 0.37% in the period of 1994-2000, electricity and water sectors received 0.35%, construction 0.90%, and transport infrastructure 0.52% (figure IV.2).\footnote{See Arroyo Picard et al. (2003) for more detailed on the omitted figures in figure IV.3.}

Unfortunately, these areas and sectors have not only been marginalized by foreign investors, but they have not received much attention from domestic investments either.
The second largest recipient sector of inward foreign investment during the period of NAFTA in Mexico has been the financial sector, accounting for 14.1% of the total (figure IV.2). However, this has mostly taken place in the form of M&As, which, as discussed in Chapter II, generates few benefits for development.

Furthermore, it is also important to point out the fact that a great part of Mexican inward FDI comes from one country, the US. In fact, the US accounted for 73% of total FDI yearend 2000, which means that Mexico suffers a high degree of dependency, not only on US economic performance, but also on NAFTA investment provisions.

Today, Mexico is not only losing old FDI projects to cheaper labor places as well as its competitiveness to attract new FDI,\textsuperscript{118} but it has also been unable to upgrade the type of FDI that flows into the economy. This has been partially due to the underutilization\textsuperscript{119} and low connection of the large FDI inflows during the first years of NAFTA, which did not accrue any real dynamic benefits that would upgrade the Mexican economy as a whole (Arroyo Picard et. al., 2003). But most importantly, this clearly reflects the total neglect of the government in shaping and overseeing the investment dynamics in the country towards meeting its development goals.

In contrast, the ASEAN schemes have been, comparatively, more restrictive as far as performance requirements and general foreign investor’s concessions. This has allowed, to a certain extent, the respective local governments to play a proactive role in directing FDI projects. For example, the AICO scheme has permitted the ASEAN

\textsuperscript{118} According to UNCTAD (2006d) figures, Mexico’s FDI inflows have decreased since their pick in 2001 – about US$27.5 billion, sharply dropping to US$19 billion in 2006.

\textsuperscript{119} According to FDI Indexes created by UNCTAD, Mexico has been underperforming according to its potentials for the past years (http://www.unctad.org/Templates/Page.asp?intItemID=2468&lang=1#).
governments to strategically direct on average 85% of total inward FDI during the period from 1999 to 2006. That is US$208 billion out US$241 billion, which came on “Approval and Appointment Basis” (ASEAN Secretariat, 2005). Of course, further analysis is necessary at the disaggregated level to figure out if these investments went to the “right” areas and sectors to avoid enclaves, as it has been the case in Mexico.\textsuperscript{120}

Perhaps at this point it is also pertinent to briefly take a look at the geographical distribution of inward FDI among ASEAN members, which could be of some relevance to the individual economic development of each of them. That is also because any aggregate analysis of ASEAN evolvements can be bias when compared to NAFTA. Indeed, the geographical distribution of inward FDI in ASEAN is quite uneven with countries like Singapore who attract the lion’s share of the total amount (figure IV.4). This is certainly not good news for members like Cambodia, Laos, and Myanmar, which so far have been largely left out of picture, receiving a mere 0.7%, 0.2% and 1.6% of the total respectively (figure IV.4). However, as pointed out by Plummer and Cheong (2008, p. 6), these countries, and perhaps the entire ASEAN zone, could have been performing much worse without Singapore in the field, which serves as both an \textit{entrepot} center for intra-ASEAN trade and a hub for FDI. Hence, while Singapore apparently does extremely well by almost any measure in attracting FDI, its destiny in many ways is linked to the economic performance of the region.

Besides, unlike the marginalized states in Mexico, which have not experienced much investment from the enclave FDI areas, the marginalized ASEAN countries such as Myanmar, Laos, and Cambodia received, in the period of 1995-2000, a very significant

\textsuperscript{120} Mainly due to data restrictions, such analysis is not provided here. Few links to some of these data can be found at ASEAN Secretariat’s at: \url{http://www.aseansec.org/}. Also, see Chapter V for few other details.
part of their total FDI inflows from other ASEAN countries, 28%, 51%, and 20% respectively (ASEAN Secretariat, 2005).

**Figure IV.4. FDI in ASEAN by Host Country, 1995-2004**

Source: ASEAN Secretariat, ASEAN Statistical Yearbook (2005).

There is another aspect of FDI in ASEAN that is important to point out as different in comparison to what has been taking place in Mexico. FDI in ASEAN seems to have been occurring in a more “diversified” manner among sectors and among industries within sectors. For instance, although the manufacturing sector in ASEAN has received a great part of total inward FDI, it is nowhere near the monopolization that has taken place in Mexico in this sector, 34% and 62.87% respectively (figure IV.2). This has allowed a greater number of other complementary sectors to internally develop in ASEAN. Moreover, the number of industries involved within the manufacturing sector also appears to be more diverse in ASEAN (figure IV.5) than in Mexico, which mostly only includes two – autos and electronics.

**Figure IV.5. Top-10 Intra-ASEAN FDI into Manufacturing, 1999-2004.**

Source: ASEAN Secretariat, ASEAN Statistical Yearbook (2005).
Furthermore, diversification of FDI in ASEAN is not only confined to sectors and industries, but it is also present in the very origin of such investments. Unlike Mexico that largely depends on US investment, the ASEAN-10 have been able to keep a constant inflow of FDI from countries all over the world, such as Japan, the EU, the US, numerous Newly Industrialized Economies (NIEs) in Asia including South Korea, Taiwan, and Hong Kong, as well as from DCs such as China and India, which although they have small shares, still do contribute to the overall diversification of inward FDI (figure IV.6).

![Figure IV.6. FDI in ASEAN by Source Country, 1999-2004](image_url)

Source: ASEAN Secretariat, ASEAN Statistical Yearbook (2005).

According to UNCTAD (2006d), the origin of FDI can be an important determinant in attracting FDI, but most importantly, it might also largely influence the amount of dynamic benefits that the host economy could derive from such FDI. For example, inward FDI from TNCs from DCs can oftentimes result more beneficial than FDI from TNCs from developed countries, mainly because the characteristics of TNCs from DCs tend to be more in line with the overall needs of host-DCs, since they come from DCs themselves. This implies a narrower technology gap between host and home firms,\(^\text{121}\) generating easier to absorb technology spillovers. It could also translate into

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\(^{121}\) Aslanoglu, 2000; Kokko, 1996; and Liu et. al., 2000 (in UNCTAD, 2006d, p. 188) concluded that the technological gap between home and host firms was successfully closed when it was initially significantly small, but when the gap was critically larger, it would widen even further in subsequent years. (the studies refer to Mexico, United Kingdom, and Turkey).
more employment opportunities given the level of skill in DCs\textsuperscript{122} and greater backward and forward linkages with local firms since home and host economic structures are similar, and thus, easier to replace home-products with host-economy-products (income similarities). In other words, given the similar economic and business cultures and similar production processes, it is more likely that TNCs from DCs, as opposed to the ones from developed countries, are more beneficial from a development perspective. Hence, because the ASEAN zone has more diversified FDI inflows, with large amounts coming from DCs, it could be suggested that the ASEAN-10 might have benefited more from inward FDI than Mexico under NAFTA. It could also further explain the overall different impact on development that the ASEAN-10 and Mexico have experienced.

To sum up, from the discussion in this chapter, a rather evident difference emerges in comparing Mexico’s experience under NAFTA’s investment provision and the experience of the ASEAN-10 from the ASEAN investment schemes. That is, given the more conservative approach to the overall management of FDI, the ASEAN-10 have, at least, been able to maintain some sort of control in directing inward FDI. Partially, this has resulted in a more “diverse” FDI atmosphere as far as distribution and the origin of foreign investments is concerned. This, in turn, allows the local economies to reduce the risk of “dependency” on enclave development sectors and economic slowdowns in the source of foreign investments. By the same token, this has increased the possibility of capturing a greater part of dynamic gains resulting from different types of FDI, a subject that I will briefly discuss in the next chapter.

\textsuperscript{122} On average per foreign affiliate, UNCTAD (2006d) reports that TNCs from DCs were found to employ more local workers – especially in low-skill industries, than those from developed countries for every million of US$ spent.
CHAPTER V: A BRIEF DEVELOPMENT REVIEW

Many economists have repeatedly stated that it is extremely difficult to disentangle the actual effects of PTAs on an economy, for the reason that there are many other non-PTA factors and circumstances involved in the changes that the economy experiences.\(^{123}\) Hence, by no means, the content of this chapter is to be interpreted as the exclusive effect of NAFTA and the ASEAN schemes (AFTA, AIA, and AICO) on Mexico’s and the ASEAN-10’s development, respectively. Nonetheless, it is also unrealistic to expect no contributitional effect from these agreements on their respective economies, since both accords, as discussed in the previous two chapters, have somewhat influenced the trade and foreign investment patterns of Mexico and the ASEAN-10.

By looking at some common indicators based mainly on the discussions in this research, this chapter reviews the economic development evolution that Mexico and the ASEAN-10 have experienced during their respective PTA era. However, I want to strongly emphasize that the intent of this chapter, and that of the entire research for that matter, is not to present a “quantitative” potential effect of the PTAs discussed here; rather, it merely attempts to offer a “qualitative” analysis of what could have happened given the relevant circumstances.

\(^{123}\) See for example, Krueger (1999a); Ramirez (2003); and Baldwin and Venables, 1995 (in Lo Turco 2003, p. 10).
5.1. Mexico’s Economic Development Evolution

In January 1st of 1994, NAFTA took full effect as the first agreement of its kind involving developed countries and DCs. Immediately after, as Carlsen (2005) puts it, “promoters began to identify it as the project that would usher Mexico into the First World, leaving behind decades of intransigent poverty and underdevelopment”. This was despite the fact that in NAFTA’s objectives (Art. 102),124 there is nothing that “specifically” refers to the agreement as an instrument to enhance growth and development or to achieve income convergence; rather, its main objective was, and remains, to exclusively eliminate trade and investment barriers.

Nonetheless, supporters quickly identified the elimination of tariffs and foreign investment regulations as the assurance for Mexico to benefit from increased market access and inward foreign investment. In other words, the long-delayed process of economic development could finally take off for Mexico. Accordingly, several judgments were made on the potential impact that NAFTA would have on Mexico’s economy. UNCTAD (2007b, p. 65) presents a summary of these estimates as follows:

Estimation exercises in the run-up to NAFTA, mostly based on applied general equilibrium models, produced various results, depending on the methodology and assumptions. A review of several of these studies by the United States Congressional Budget Office (1993) found a consensus that NAFTA would produce winners and losers, but a total net gain. The effects on Mexico were expected to be the most substantial, because of its greater trade barriers and smaller economy than those of its NAFTA partners. Most of the studies estimated that improved resource allocation as a result of trade liberalization under NAFTA would raise Mexico’s GDP, but by less than 1.1%. When the effects of economies of scale were included, estimates of the increase in Mexico’s GDP ranged from 1.7% to around 3.4%, but they were even much higher if investment effects were also considered, ranging from 3.1% to around 12.7%. Moreover, according to this review, the most important effect would come from productivity growth and technology spillovers.

124 For a full list of NAFTA’s objectives go to: http://www.sice.oas.org/trade/nafta/chap-01.asp#A102.
Furthermore, for Mexico, the biggest winner of the agreement, there were also expected large benefits as far as employment and real wages go. Ramirez (2003) reports that, it was expected that as much as a 6.6% increase in employment and a 12% increase in real income, or more, by the end of NAFTA’s phased implementation would take place. Moreover, Hufbauer and Schott (2005) point out that Mexican political leaders optimistically promised that NAFTA would generate one million new jobs each year and begin to address the misery of subsistence labor in rural areas.

However, comparing the above estimated figures to the actual evolution of the Mexican economy during the more than ten years of NAFTA’s implementation, it appears that NAFTA has succeeded in meeting its “listed” objectives, increased trade and investment flows, but has fallen short in meeting the expectations in other aspects.

From a traditional Viner’s perspective, NAFTA has mostly resulted in trade creation at the aggregate level according to several authors. However, at the disaggregated level, some studies have found trade diversion in the textile and apparel sectors. These are interesting findings, especially because Mexico could have largely benefited from increased market access in these sectors, in which it enjoyed a comparative advantage. It appears that Mexico ended up on the “losing” side in this case, mainly due to NAFTA’s restrictive RoO (Chapter III, p. 54).

However, as I have argued previously, this paper is not concerned with the “static” outcome of PTAs. Rather, it takes a dynamic approach, observing other potential

125 See for example, Krueger (1999b); Soloaga and Winters, 2001; Gould, 1998; and World Bank, 2003 (in Lesher and Miroudot, 2005, p. 31).

126 See for example, ITC, 1997; Fukao, Okubo and Stern, 2003 (in Lesher and Miroudot, 2005, p. 31), and more recently, Cadot et. al. (2005).
benefits that might have resulted from market access and inward foreign investment, which presumably have both increased (figures III.1, III.2 and IV.1). Hence, it is only adequate to analyze the dynamic gains that might have matured to Mexico, namely physical capital formation and economic activity, employment and wages, technological spillovers, and human capital and skill enhancement.

First, in Chapter II (p. 28), it was concluded that a PTA enlarges the market, and so, it presents the opportunity to generate physical capital formation and economic activity from exploiting economies of scale and productivity gains. However, given the discussion in Chapter III, this opportunity was largely reduced in Mexico simply because there was very little actual market access, despite the significant increased in export-flows. In part, this was due to NAFTA’s overall structure and restrictive RoO, but it was also largely due to consumption patterns differences in NAFTA as well as Mexico’s supply capacity constraints.

Foreign investment should have also contributed to physical capital formation and economic activity, since FDI tremendously increased (figure IV.1). However, also due in part to the unrestrictive NAFTA’s investment provisions that were given to foreign investors (Chapter IV, p. 84), the Mexican government’s ability to direct it towards its development goals was largely reduced. This resulted on enclave FDI destinations, areas and sectors, highly disarticulated from the rest of the economy (figures IV.2 and IV.3) and on large capital flights due to “transfer-pricing”.

As a result, gross fixed capital formation (GFCF) as a share of GDP has remained at around 20%, which is below the

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127 Ramirez (2003) reports that remittances of profits and dividends more than double between 1990 and 2000, going from US$2.3 to US$5.2 billion, or 55.6% in average of the FDI inflows.
25% level generally understood to be required for a sustained process of catch-up growth in a middle-income country such as Mexico (UNCTAD, 2007b).

Second, as presumed by NAFTA promoters and concluded in Chapter II (p. 29), the agreement should have resulted on more and better paid jobs. However, in reality, as Ramirez (2003) puts it, employment growth and real wages in Mexico during NAFTA have been lackluster at best and disastrous at worse (see figure V.1). Some recent statistics (based on “official” unemployment) have tried to show the positive impact that NAFTA has had on Mexico’s unemployment, which has dropped from 6.4% in 1995 to almost a constant level between 2.5% and 3.0% thereafter (Ramirez, 2003). But even the Mexican government has admitted the low reliability of these measures due to the large informal employment sector that currently accounts for almost one third of the Mexican labor force (ibid). Indeed, many argue that a better measure for Mexico’s unemployment rate must include the underemployed labor force, which has remained constant, or even increased, during the NAFTA period – at around 20%.

There were jobs created during the first years of NAFTA, which resulted in a 1.2% annual growth rate, but that was well below the 2.5% needed to absorb the yearly 1.2-1.5 million new entrants (Ramirez, 2003). After 2000, however, in part due to the 2001 US recession, and in part due to China’s competition after its WTO accession, job creation has decreased even in the most vibrant sector, the maquiladora plants, which have been directly impacted by NAFTA factors. This is in spite of 45% productivity increase on average (figure V.1). Moreover, Arroyo Picard et. al. (2003) point out that NAFTA jobs have not been good jobs. They have been low paying jobs without any

128 See also Sáinz, 2006 (in UNCTAD, 2007b, p. 77).
basic benefits. Likewise, the performance of real wages has not been the exception. There has been a steady erosion of purchasing power of both minimum and average wages in the ‘90s, loosing 23% of its value between 1993 and 1999 (Ramirez, 2003).

**Figure V.1. Labor Factor in Mexican Manufacturing Branches: 1993-2000**

<table>
<thead>
<tr>
<th>Productivity</th>
<th>Employment</th>
<th>Real Wages</th>
<th>Labor Cost (DLS)</th>
</tr>
</thead>
<tbody>
<tr>
<td>30%</td>
<td>-1%</td>
<td>-5%</td>
<td>-17%</td>
</tr>
<tr>
<td>16%</td>
<td>-2%</td>
<td>-18%</td>
<td>-26%</td>
</tr>
<tr>
<td>11%</td>
<td>-10%</td>
<td>-14%</td>
<td>-21%</td>
</tr>
<tr>
<td>25%</td>
<td>-5%</td>
<td>-13%</td>
<td>-24%</td>
</tr>
<tr>
<td>43%</td>
<td>-1%</td>
<td>3%</td>
<td>-3%</td>
</tr>
<tr>
<td>38%</td>
<td>-20%</td>
<td>-17%</td>
<td>11%</td>
</tr>
<tr>
<td>70%</td>
<td>20%</td>
<td>24%</td>
<td>-41%</td>
</tr>
<tr>
<td>80%</td>
<td>10%</td>
<td>-7%</td>
<td>-45%</td>
</tr>
<tr>
<td>54%</td>
<td>20%</td>
<td>-3%</td>
<td>24%</td>
</tr>
</tbody>
</table>

Source: Adapted from Arroyo Picard et. al. (2003, p. 65)

Thirdly, as discussed in Chapter II (p. 30), technology upgrading is perhaps the most important factor of growth in today’s highly technological world. Hence, benefiting in this area might have been one of Mexico’s greatest gains from increasing trade and investment activity with two of the world’s top innovators. Unfortunately, measuring technological spillovers resulting from a PTA is not a simple task. Nonetheless, some authors such as Lall (2000b) have attempted to do so, by analyzing the evolution of the technology embedded in traded goods.

UNCTAD (2007b) takes the same approach in the case of Mexico during NAFTA. This study points out that a large part of Mexican exports during NAFTA have been high skill and technologically advanced products.\(^{129}\) However, this does not imply that Mexican production systems have been upgraded, for that high-technology products may result from low-technology processes. This is because the large bulk of imports to Mexico are already high skilled and technologically advanced products, allowing mere

\(^{129}\) UNCTAD (2007b, p. 73) reports that only 17% of manufactured Mexican exports are characterized by low-skill-technology.
assembly activities with low skill and technological content to take place in the Mexican side of the border. This suggests, as UNCTAD (2007b) further argues, a relatively insignificant change in the technological base of Mexico. Rather, Mexico has been locked-in in the exploitation of its initial comparative advantage, low-cost and abundant labor. Partially, as previously discussed, all this can be attributed to factors such as NAFTA’s overall trade and investment design as well as its restrictive IPR package, Mexico’s low absorbing capacity, and most importantly, to the overall passive role of the government in the process.

Lastly, NAFTA could have contributed to Mexico’s human capital and skill enhancement (Chapter II, p. 32). However, this is still a mere theoretical argument quite difficult to put into practice because an extensive package of domestic policies and an active role of local agents are both required (Lee, 2005). Besides, these benefits are not easy to be captured and measured. Nonetheless, some insights (non-NAFTA related) can highlight how much Mexico could have benefited from NAFTA in this area. For example, one could look at the Human Development Index (HDI), before and during NAFTA, (see figure V.2). But although it shows a gradual improvement, it leaves the open question of what would have happened had Mexico invested more on education.\footnote{Compared to US and Canada, Mexico still lags largely behind as far as years of schooling and expenditure on education per inhabitant, demonstrating Mexico’s workers level of skill compared to that of its NAFTA partners. Guisan et. al. (2003, p. 7) report that in average during the period of 1995-99 the years of schooling in Mexico were at 6.55 compared to 12.21 in the US. Moreover, Mexico spent US$500 per year (at 1999 prices and PPPs), which is less than a third of that in the US.}

Moreover, some studies in Miyamoto (2003, p. 29) show that only 11% of TNCs in Mexico invested in in-house training compared to figures ranging from 65 to 75% in other countries such as the Philippines, Singapore, and China.
Figure V.2. Historical Trend of Mexico’s HDI, 1975-2005.

Source: Author’s creation from: UNDP (2007).

To sum up, Mexico could have largely benefited from NAFTA as it was predicted by both trade theory and estimates in the run-up, but unfortunately due to all the circumstances discussed throughout this thesis, the overall positive effect has been quite modest and even negative in some instances. Not only the Mexican economy did not grow anywhere close to the 12.7% predicted by some estimates above, but it actually has performed worse than in previous periods (figure V.3). Moreover, as Arroyo Picard et. al. (2003) point out, during NAFTA, GDP per capita growth in Mexico has being at the second lowest level during its the entire modern history since the 1930’s with the exception of the 1982 crisis (figure V.4). In short, in describing NAFTA’s impact on Mexico, an anecdotal medical proverb comes to mind: “the surgery was successful, but the patient died”. In the sense that NAFTA succeeded in doing what it was set out to do, it increased trade and foreign investment flows, but Mexico did not ultimately succeed in kicking off its economic development process.

131 Several studies support this argument; see for example, Arroyo Picard et. al. (2003); Ramirez, (2003); UNCTAD, (2007b), which in p.67 lists numerous other studies, such as Moreno-Brid, Ruiz Nápoles and Rivas Valdivia, 2005, Hufbauer and Scott, 2005, Blecker, 2003, and Audley et. al. 2003.

132 See the cited authors for a more detailed discussion of Mexico’s GDP per capita growth, before and during the years of NAFTA. See also Figure V.8, which is based on UNCTAD data, reflecting similar trends, and also compares Mexico’s figures with that of the ASEAN-10.
5.2. ASEAN-10’s Economic Development Evolution

As mentioned before, disentangling the effects of trade and investment schemes on economies can be a very challenging task. Indeed, this has been the case of NAFTA’s impact on Mexico, which, to a certain extent, has been a more evident process, providing more available data. What this means is that at least NAFTA was implemented all at once in a single package. Hence, proving a “reliable” assessment of the impact that the ASEAN schemes have had on the economic development of the economies involved, which among other factors, entered at different times into the agreements can be an almost impossible endeavor. Nonetheless, mainly following the above structure on NAFTA’s impact on Mexico, this section attempts to provide some insights that may loosely reflect ASEAN schemes’ impact on the ASEAN-10.

ASEAN (as whole) has been a long-lived association mainly born out political tensions among countries in Southeast Asia, and it has been subject to continuous (up to
date) modifications. Although, “the acceleration of economic growth and social progress” is explicitly listed as the first objective of the agreement, ASEAN neglected economic cooperation for the first 25 years of its existence while it mainly concentrated on its second objective – “to promote regional peace and stability” (Cuyvers and Pupphavesa, 1996). Unlike Mexico in NAFTA, which place all its development affords at once on the NAFTA project, the ASEAN members have taken the time to understand the potentials of regional integration and have also diversified their development projects in many different unilateral initiatives.

The slow progress of ASEAN integration, as pointed out in Cuyvers and Pupphavesa (1996), has been justified due to the fact that, at the early stages, the country members were hardly, if at all, complementary economies. They all followed widely different development strategies, from free trade in Singapore, to export promotion in Thailand and Malaysia and import substitution in Indonesia and the Philippines. ASEAN had to wait until the liberalization policies in Indonesia, Malaysia, the Philippines, and Thailand in the second half of the 1980s, to find the economic policy priorities between the ASEAN-countries as sufficiently converged in order to allow for the next steps in economic cooperation. Something that was not seen at all in the case of the NAFTA members, which engaged immediately in a reciprocal economic cooperation despite of the asymmetries between Mexico and the other members.

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133 It has increased the number of members from 5 to 10; it has formed various schemes, among them a PTA in 1977, and several projects for industrial cooperation such as AIP, AIC, and AIJV, culminating with the formation of AFTA, AIA, and AICO during the ‘90s. Moreover, ASEAN has stated talks about creating European Union like bloc by the year 2020 – the ASEAN Economic Community (see Shimizu, 2007 for further discussion) (also see Chapter III).

134 For an original version of ASEAN objectives go to: [http://www.aseansec.org/1212.htm](http://www.aseansec.org/1212.htm)
Substantial economic integration among ASEAN members occurred until 1992 with the formation of AFTA. Like NAFTA, the main objectives of this FTA were to liberalize trade and stimulate foreign investment in the region. In addition, ASEAN members created other schemes (AIA and AICO) in order to further attract foreign investment (Chapter IV). But unlike NAFTA, these schemes were much less identified as projects that would bring the ASEAN-10 out of their developing country status.

ASEAN Schemes were not preceded by any “number-crunching”. As Cuyvers and Pupphavesa (1996) put it, the mood was to: “Agree First, Talk Later”. However, the few estimation studies of the economic (static) impact on the ASEAN economies generally expressed an insignificant effect, mainly among other reasons due to the relative similar factor endowments, low trade patterns among members, and to the overall characteristics embraced in a S-S PTA as discussed in Chapter I. The main prediction was that AFTA would mostly result on trade diversion, and AIA and AICO would have a trivial impact on inward foreign investments.

The actual outcomes have been tested by several authors with a quite mixed set of results. For example, Hapsari and Mangunsong (2006), using gravity models, conclude that AFTA overall has been a trade-diverting agreement. However, Cernat (2003), also using gravity models, concludes that AFTA has been one of the best performing current S-S PTAs, resulting in trade creation, despite of its slow process of integration. Yet, other studies, such as those done by Hakim (2004) and Tho (2002), conclude that at the disaggregated level (countries instead of sectors), AFTA has resulted in trade creation for

135 For example, Cuyvers and Pupphavesa (1996, p. 11) cite studies, such as Nadal De Simone (1996: 106) and Chirathivat (1996: 29), which calculated that trade liberalization under AFTA will induce for the ASEAN countries hardly 3 or 4 billion US dollars, and mainly result on trade diversion.
some members and trade diversion for others but overall trade creation with the rest of
the world. In addition, as highlighted in chapters III and IV, there are studies that have
tested the actual efficiency of the ASEAN schemes in meeting their initial goals, which
were to increase trade and inward foreign investment. One example is Elliot and
Ikemoto, 2004 (in Lendle, 2007, p. 6), which suggests that AFTA had no impact on intra-
ASEAN trade. In regards to foreign investment, Plummer and Cheong (2008)
conclude that AIA in particular has had an overall positive impact on intra-ASEAN FDI
flows, but it has not have any impact on extra-ASEAN flows.

Again, this research is not as concerned with the static outcomes of PTAs as it is
on the dynamic benefits that can be obtained from them. Indeed, supporters of the
ASEAN schemes, especially AFTA, vindicated that the real benefits were be obtained
from the dynamic effects on economic growth, as pointed out by Cuyvers and
Pupphavesa (1996, p. 11), who refer to studies such as Yap and Edillon (1993), Imada
(1993), and Ramasamy (1994 and 1995). Therefore, below I will present a brief review
of the potential dynamic gains that the ASEAN-10 could have accrued.

First of all, because AIA reserves the right to restrict transfer-pricing if it deems
necessary (Chapter IV, p. 80), it could be expected that the ASEAN-10 would have
gained more from inward FDI, not only to accumulate physical capital, but also to reduce
financial instability during the time of crisis, thereby preventing large capital flights. As
a matter of fact, this right has been evoked by Malaysia during the Asian Crisis of 1997

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136 Note that most of these studies confined their research, mainly for data restrictions, to the five largest
members of ASEAN (Singapore, Indonesia, Malaysia, Thailand and the Philippines).

137 Lendle (2007, p. 6) suggests that this is not very surprising given the evidence for low tariff utilization
rates. He refers to empirical evidence (p.9) from Baldwin (2006), who reports that, for example, utilization
rates in 2002 have only been 4% for Malaysia and 11% for Thailand.
(UNCTAD, 2007b). Another factor that could have influenced the retention of inward-FDI and eventually convert it into physical capital is the fact that foreign investors in the ASEAN zone are much more diversified, coming from both developed and DCs (Chapter IV).\textsuperscript{138} However, figure V.5 reflects a different story, mainly for Thailand and Indonesia, but it also seems to have had some positive influence on Cambodia and Vietnam. Of course, this data is a mere illustration of the physical capital formation trends that have been taking place in ASEAN, and it is not to be interpreted as a result of PTA envelopments in the area. Rather, other factors such as the 1997 Asian Financial Crisis could have had a real direct impact.

**Figure V.5. Gross Capital Formation Trends in the ASEAN-10.**

<table>
<thead>
<tr>
<th>Year</th>
<th>Brunei</th>
<th>Cambodia</th>
<th>Indonesia</th>
<th>Laos</th>
<th>Malaysia</th>
<th>Myanmar</th>
<th>Philippines</th>
<th>Singapore</th>
<th>Thailand</th>
<th>Vietnam</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990</td>
<td>8.30%</td>
<td>30.70%</td>
<td>32.40%</td>
<td>24.20%</td>
<td>37.10%</td>
<td>41.40%</td>
<td>12.60%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2000</td>
<td>16.90%</td>
<td>22.20%</td>
<td>27.30%</td>
<td>21.20%</td>
<td>33.30%</td>
<td>22.80%</td>
<td>29.60%</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Author’s creation with data from UCTAD (2006d).

Secondly, it appears that the effect of any aspect of economic integration and/or PTAs on employment is still mostly a theoretical argument. At least, specific studies at the disaggregated-sector and subgroup level are needed to capture the dynamic impact that a particular PTA could have on employment and wages, as Jansen and Lee (2007) argued. Several studies have been undertaken in the case of NAFTA and its impact on Mexico’s employment. However, this is not the case, to my knowledge, in the ASEAN countries. Therefore, my discussion in this respect will be limited to observe the

\textsuperscript{138} UNCTAD (2006d) reports that, in average during the ‘90s TNCs from developed countries have tended to repatriate a larger portion of their profits (50 to 60%) than TNCs from DCs, which suggests that TNCs from DCs reinvested more of their profits in the local economy, increasing the opportunity to increment total physical capital formation for the host economy.
“official” unemployment trends in the ASEAN-10 during the period of AFTA (table V.1). From observing table V.1, can be concluded that AFTA did not have any particular positive impact on the ASEAN-10 employment levels. Rather, it seems that it has negatively affected some countries such as the Philippines, and Indonesia. Note also, however, that the figures below might be even worse if rural and disguised unemployment as well as underemployment are included as in the case of Mexico. Nonetheless, ASEAN authorities have identified and recognized this social problem and have started regional cooperation in tackling the existent high unemployment level along with the process of economic integration.\footnote{See for example, the various initiatives started in 2006 by ASEAN authorities, aiming at improving social problems in ASEAN, such as poverty and unemployment (http://www.aseansec.org/21009.htm).}

<table>
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<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Brunei Darussalam</td>
<td>3.9</td>
<td>3.3</td>
<td>3.7</td>
<td>3.5</td>
<td>4.2</td>
<td>5.6</td>
<td>3.5</td>
<td>4.5</td>
<td>4.8</td>
</tr>
<tr>
<td>Cambodia</td>
<td>0.9</td>
<td>0.7</td>
<td>0.6</td>
<td>0.5</td>
<td>2.5</td>
<td>1.6</td>
<td>0</td>
<td>0</td>
<td>0.3</td>
</tr>
<tr>
<td>Indonesia</td>
<td>4.9</td>
<td>4.7</td>
<td>5.5</td>
<td>6.4</td>
<td>6.1</td>
<td>8.1</td>
<td>9.1</td>
<td>8.5</td>
<td>9.8</td>
</tr>
<tr>
<td>Laos PDR</td>
<td>4.2</td>
<td>5.0</td>
<td>5.0</td>
<td>6.0</td>
<td>7.0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Malaysia</td>
<td>2.6</td>
<td>2.5</td>
<td>3.2</td>
<td>2.4</td>
<td>2.4</td>
<td>3.5</td>
<td>3.6</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Myanmar</td>
<td>4.1</td>
<td>4.1</td>
<td>4.1</td>
<td>4.1</td>
<td>4.0</td>
<td>4.0</td>
<td>4.0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>The Philippines</td>
<td>7.4</td>
<td>7.9</td>
<td>9.6</td>
<td>9.4</td>
<td>10.1</td>
<td>9.8</td>
<td>10.2</td>
<td>10.2</td>
<td>10.9</td>
</tr>
<tr>
<td>Singapore</td>
<td>3.0</td>
<td>1.8</td>
<td>2.4</td>
<td>4.8</td>
<td>4.4</td>
<td>3.4</td>
<td>5.2</td>
<td>5.4</td>
<td>5.3</td>
</tr>
<tr>
<td>Thailand</td>
<td>1.1</td>
<td>0.9</td>
<td>4.5</td>
<td>3.3</td>
<td>3.6</td>
<td>2.4</td>
<td>1.6</td>
<td>1.6</td>
<td>1.5</td>
</tr>
<tr>
<td>Viet Nam</td>
<td>5.9</td>
<td>6.1</td>
<td>6.9</td>
<td>7.4</td>
<td>6.4</td>
<td>6.3</td>
<td>5.5</td>
<td>5.5</td>
<td>5.5</td>
</tr>
</tbody>
</table>

Source: Compiled from data submission, surveys, and statistical yearbooks of AECs national statistical offices and relevant government departments/ ministries and ILO Labourstat Database.

Notes: \( * \) preliminary as of date of compilation.
\( ^{n.a.} \) not available at the time of publication.
\( ^{+} \) Unemployment rate only in urban area.

Thirdly, as in the case of Mexico, assessing how much the ASEAN-10 have benefited from technology spillovers resulting from increased trade and inward FDI can be proven quite challenging. Nonetheless, there are some differences between NAFTA’s FDI regulations and the ASEAN schemes, especially AICO, that might suggest that the ASEAN countries could have gained more in this area. First, the approach to IPR regulation in ASEAN has been more relaxed than in the case of NAFTA, which can be
proven to be beneficial for the technology upgrading of the ASEAN-10 given their level of economic development (Chapter IV, p. 80-81). Second, and certainly more important, the set up of the AICO scheme has allowed the ASEAN-10 to have some sort of policy space to strategically direct inward FDI projects. This is because it requires foreign investors to engage in some sort of “sharing”, including technology, creating a more “restrictive” regime for foreign investors as far as performance requirements and local content usage (Chapter IV, p. 93). As such, AICO has “required” TNCs to form a more interactive atmosphere with local firms, increasing the potential for technology transfers and diffusion.

Contrary to the believe that restrictive FDI regimes discourage foreign investors, recent statistics show that many TNCs, mainly auto-makers such as Toyota, Honda, Nissan, and other US and European firms, have shown tremendous interest on the AICO projects. Shimizu (2007) reports that, by July 2006, there were 141 approved AICO ventures, generating US$1.7 billion in traded goods. Moreover, 150 applications, from American companies alone, are been currently processed (US-ASEAN Business Council, 2008). These projects have enabled the ASEAN-zone to emerge as an important player in the auto industry, not only in the production of foreign brands, but also, progressively, in the production of home-grown brands. For example, Shimizu (2007, p. 84) documents that Toyota has began to produce a strategic world car: the Innovative International Multipurpose Vehicle (IMV) in Thailand for the first time in the world in August 2004, which hardly depends on Japanese parts, and it is not based on any Japan-made model.

140 See Lall and Albaladejo (2002) for a detailed discussion on IPR and the level of development.

141 UNCTAD (2006d, p. 187) reports that 33% of TNCs in Singapore, Malaysia, Indonesia, the Philippines, and Thailand sourced from local inputs, compared to a mere 1-3% in Mexico.
Although this project has been mainly concentrated in Thailand, it has created a wide intra-regional production network, which mainly sources from other ASEAN countries that complement the production chain (ibid). Hence, it could be loosely concluded that the ASEAN schemes have contributed somewhat to the overall ASEAN technology base, something that has hardly occurred in the case of Mexico.

Lastly, the ASEAN-10 could have also benefited from increased trade and inward FDI in the area of human capital and skill enhancement, but as I already mentioned, it is quite difficult to capture and measure such benefits. As in the case of Mexico, the HDI in the ASEAN-10 seems to have been gradually improving without any important variations during the period of all the ASEAN schemes (figure V.6). But again, is quite irrelevant to base any judgments on this index. Rather, some other observations can provide better insights of how the ASEAN-10 have been evolving in this area in order to be able to capture a greater part of the benefits potentially provided. Also, it is important to point out the wide differences in the overall level of education and skill available among ASEAN members. This could have resulted on a biased distribution of this type of dynamic gains from economic regional integration.

**Figure V.6. HDI Evolution in Mexico and the ASEAN-10 (1975-2005)**

![HDI Evolution in Mexico and the ASEAN-10 (1975-2005)](image)

Source: Author’s creation with data from: UNDP (2007).

Nonetheless, the ASEAN members have associated efforts in diverse areas that can improve the human capital stock of the entire zone allowing for an increase in the
absorbing capacity of all members. For example, there has been created an ASEAN University Network, promoting general education in the fields of science and technology. Also, aggregate cooperation has emerged in the areas of health and nutrition, culture and information, drugs and narcotics, and disaster management, among others (ASEAN Secretariat, 2007b). Unfortunately, the same developments have not been seen in the case of NAFTA, where “deep-integration” has not gone beyond exploiting trade and investment opportunities.

To sum up, despite some of the difficulties encountered in pointing out the dynamic benefits that the ASEAN-10 could have obtained from engaging in their respective trade and investment schemes and the overall mixed results from static models, it seems that, at the aggregate level the ASEAN-10 have somewhat largely benefited from AFTA, AIA, and AICO as far as pure economic performance is concerned. This is reflected on their relatively high constant annual GDP growth rates, before and during the period of these schemes (figure V.7). Although the five largest members, Singapore, Thailand, Indonesia, Malaysia, and the Philippines, were severely hit by the 1997 Asian Financial Crisis, they were able to bounce back after the year 2000. On the other hand, the ASEAN schemes seem to have paid extremely well to the late ASEAN joiners, Brunei, Cambodia, Laos, Myanmar, and Vietnam, hitting record high growth rates since their ASEAN membership (figure V.7).

Moreover, GDP per capita growth appears to have evolved in the same matter as GDP growth for all members (figure V.8). It slightly dropped during the 1997 Crisis for the founding members, but recuperated immediately after. And, it has been sharply

142 For further information on these developments go to: http://www.aseansec.org/8558.htm.
increasing for the late ASEAN comers (BCLMV) at impressive rates right after their membership into ASEAN, going from an annual growth rate of mere 0.66% during the ‘70s and ’80 to an aggregate 5.88% during the period of 2000 and 2005 (figure V.8). Have the developments of economic integration in the ASEAN contributed to this? This is perhaps an interesting subject for further and more detailed research. However, one thing seems to be quite evident. There have been important differences in the way in which economic integration is taking place in Southeast Asia and in North America that might have had a significant impact on the development of the DCs involved, which can be reflected on the final overall economic performance of Mexico and the ASEAN-10.

**Figure V.7. GDP Annual Growth Rate in Mexico and the ASEAN-10**

![GDP Annual Growth Rate in Mexico and the ASEAN-10](image)

Source: Author’s Creation with data from UNCTAD (2006a).

**Figure V.8. GDP Per Capita Growth Rate of Mexico and the ASEAN-10**

![GDP Per Capita Growth Rate of Mexico and the ASEAN-10](image)

Source: Author’s Creation with data from UNCTAD (2006a).
CONCLUDING REMARKS

It is hoped that the main conclusions have already been drawn and understood from the various discussions throughout the corpus of this research. However, there are a few points that I would like to highlight in this concluding section by way of summarizing the main ideas embedded in this thesis.

First, it is granted that economic integration can be conducive to development. Thus, the fact that many DCs have engaged in “integration agreements” may well result in speedier development. However, it has also been noted that external integration has to synergize with an intensive process of internal integration if benefits are to be reaped. This is where it is important to remember that whether development would indeed materialize depends on the content of whatever integration agreement that is reached and the relative state of development of each of the signatories to the agreement (the latter consideration of which may shape the content of an agreement more in favor to some). The state of development of each country at any time is the cumulative result of the historical interactions of both internal and external economic (and in many cases, social) forces. The content of any integration agreement in some sense defines how the external forces would either support or obstruct the forces of internal integration when the agreement is implemented, and thus would shape the future path and trajectory of development of the countries concerned.
Indeed, and this second point follows directly from the first, in analyzing two current PTAs, NAFTA and ASEAN, this research has shown how important it is to examine the content of each PTA. Thus, while they do involve the conventional “market access” issues (Chapter III), they also cover, among other channels of integration, international investment (Chapter IV). More fundamentally, the close scrutiny in those chapters indicate that the relative bargaining power (which partly reflect the relative state of development) and the general structural asymmetries among different members shape the overall “integration intention” of each agreement, and thus result in differing “readiness” of each member to benefit from the opportunities presented.

These considerations have without a doubt played a crucial role in the developmental effects that NAFTA has had on Mexico thus far, in which integration has not gone beyond the mere exploitation of trade and investment opportunities by the stronger players in the field. On the other hand, the process of integration in Southeast Asia, although slow, has been taking a more development-friendly approach. This is not only because many of the aspects present in NAFTA were not of much concern in ASEAN, but also because ASEAN has been designed to ultimately embrace other important development aspects of economic integration and collectively address them.

The second point above is a sad reminder, and here is my third point, that the current available theories on which most assessments of PTAs are based, traditional trade theories, unfortunately contain serious shortcomings. They largely omit from the analysis or simply take for granted many the other aspects of economic integration essential for growth and development. Consequently, misleading conclusions are presented concerning the potential benefits of forming a PTA, and the form and design
they should take in order to spur the development process of the DCs involved in such schemes. Also, it is important to highlight that these theories are based on very shaky grounds and lack conclusive empirical support (Deraniyagala and Fine, 2001).

Fourth, it is also necessary to stress the fact that this comparative analysis has not attempted to present a “quantitative” assessment of the PTAs studied here. Rather, it has taken a “qualitative” approach, considering other aspects of economic integration typically excluded from conventional thinking. Indeed, given the shortsighted approach of traditional trade theories, an increasing body of literature is diverting from their postulates. Unlike orthodox evaluations that can result in different outcomes from the same subject of study (a certain PTA) because the use of different data sets, assumptions, and interpretations of the results, the overall message from this new emerging literature unanimously echoes the results obtained in this research. That is, N-S PTAs can be beneficial for development, but given the many differences among members, the benefits can be unequally distributed. On the other hand, in S-S PTAs, although there is low potential for large benefits, the few benefits generated can be more equally distributed among members. At least, the costs of trade and investment liberalization can be reduced.

Nonetheless, there is still a large untapped field for further “alternative” analysis of PTAs in many other areas that were not covered in this research, for example, the impact of foreign competition, the potential benefits that can be drawn from truly liberalizing all production factors, such as labor and not only trade and capital. But most importantly, future research in the area of economic integration must move away from

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143 See for example, UNCTAD (2005 and 2007b); Hoekman (2005); Khor (2007); and Kreinin and Plummer (2003).
orthodox analysis into more dynamic and realistic consideration of many other variables and circumstances that can offer reliable information to DCs in meeting their developmental goals when engaging in a PTA. Ultimately, this alternative research could also provide valuable insights to ensure that DCs actually benefit from trade and investment negotiations at the multilateral level like the so-called “Development Round” or Doha Round.
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