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EVSL: The Case of the Philippines**

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An Inquiry into the Long-term Prospects of the EVSL: The Case of the Philippines

Leonardo A. Lanzona and Marissa M. P. Macam*

I. Introduction

A major incentive for developing countries to seek Regional Trade Agreements (RTAs) with developed nations is the hope of acquiring market access beyond what they expect to achieve in multilateral negotiations.¹ Given the limited extent of developed nations' commitments through the Uruguay Round of multilateral liberalization, developed countries' tariff bindings may not be fundamentally altered. Though the WTO limits the use of quantitative measures, the Uruguay Round included restrictions on so-called "gray area" measures, such as voluntary export restraints. Hence, by integrating with other countries, the developing countries are able to phase and manage its exposure to the international markets, and simultaneously promote its objective of gradually liberalizing and increasing trade with developed countries.

Another argument in favor of developing country integration with developed countries is the potential to promote their recent economic reforms. The argument is that developing countries with a history of protectionist policies, state controls, and unstable macroeconomic environments will not see an influx of foreign investment unless foreign investors see these reforms as credible. If a developing country joins a regional economic bloc, however, this offers a guarantee that should instill confidence in foreign investors.

Unfortunately, the benefits from regionalization can be outweighed by its costs. With a prolonged recession due to the Asian Crisis, the gains coming from RTAs can prove to be small, if not empirically unsupported. This then brings into focus the early voluntary sectoral liberalization (EVSL) program of the Asia Pacific Economic Cooperation (APEC). The APEC Economic Leaders endorsed the EVSL of the fifteen sectors in their Fifth Meeting (AELM) in Canada in November 1997. These sectors were identified to have likely positive impacts to trade, investments and economic growth in the respective economies and the whole APEC region. These are: environmental goods, services, toys, fish and fish products, forest products, gems and jewelry, oilseeds and oilseed products, chemicals, telecommunications mutual recognition arrangement, energy sector, food sector, natural and synthetic rubber, fertilizers, automotive, medical equipment and instruments, and civil aircraft.

In the APEC Economic Leaders Meeting in Malaysia last November, 1998, however, the consensus has been to downgrade the importance of EVSL, as Japan had

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¹ Multilateral trade agreements are negotiations reached when many countries transact in groups simultaneously, as in the General Agreement on Tariffs and Trade. In contrast, regional trade agreements are transactions made only by member countries representing a certain economic bloc.

declined to offer fishery and forestry for early liberalization. The overall agreement is to elevate the fifteen sectors to the WTO process, and for each economy to move at its own pace, not as regional offers but as voluntary individual concessions. To this day, the prospect of EVSL remains unclear, and will likely lead to a reduction in the number of sectors to be offered.

This paper will argue that EVSL offers a number of opportunities in the short-run and, in the long run need not hinder, but instead promote, globalism. The EVSL can serve as the springboard towards accelerating and enhancing the trade liberalization process and thus improving the country's general welfare. In this case, the longer-term commitments to the trade and investment facilitation and economic and technical cooperation can be strengthened if major modifications that prevent discriminatory policies are implemented. The EVSL can then be pursued cautiously as long as the necessary changes can be adopted.

This paper is organized as follows: Section 2 provides an overview of APEC's liberalization program. Section 3 looks at the partial equilibrium effects of EVSL, showing conditions for and against the EVSL. Section 4 analyzes the multisectoral or general equilibrium implications of the EVSL, discussing how the EVSL can hinder further liberalization. Section 5 presents possible policy modifications that can be made to enhance the use of the EVSL.

II. Voluntarism and Regional Trade Agreements

One of the underlying principles behind the APEC's liberalization approach is "voluntarism". The economies have no obligation or commitment to open-up sectors to their respective partners or to the international markets in general. However, the EVSL is perceived to compromise this principle. For one thing, the EVSL seemed to have pushed the APEC economies into negotiations that have been previously shunned by members (Scollay, 1998). The degree by which EVSL will undermine voluntarism depends on whether the sectors offered are binding or non-binding. However, because of political pressures, each economy believes that they are being forced to make commitments, given the emphasis previously placed on the EVSL.

In any case, the issue is not whether voluntarism should be upheld or not. The key question is whether the EVSL can be directed towards a more effective process of liberalization. To do this, "harder negotiations" may be necessary in order to accelerate the liberalization process, while at the same time making it more in line with, if not more liberal than, the WTO agreement. This also suggests the EVSL should be incorporated into the individual action plans (IAPs) as a manifestation of intent for opening-up the sectors.

It must be stressed however the outward orientation in trade should not be confined to regional trade. The so-called East Asian miracle economies, such as Korea and Taiwan, considered the whole world as its trading destination. A multilateral trading system remains superior to any preferential trading arrangement, if relative factor abundance as well as technological differences—as opposed to differentiated products—are assumed to be the bases for trade.

Because of this, APEC has in fact been organized to pursue regionalism as a mechanism for multilateralism. In this case, any future directions of the EVSL should remain grounded on MFN-based regionalism, in contrast to a system geared towards preferences, whether for oneself or for developed countries. MFN by definition is non-discriminatory.² The MFN should be the only basis for trade liberalization, while pursuing regionalism in several non-trade areas such as trade and investment facilitation and technical and economic cooperation.

III. Partial Equilibrium Trade Effects of the EVSL

The crucial issue, of course, is whether or not EVSL is beneficial to the country. One way to determine the effects of EVSL is by focusing its impact solely on the sector being offered. Economic theory indicates that, for a small country, a higher tariff is inferior to a lower one. Industries that have been provided with some tariff protection generally tend to be less efficient since they are able to control the domestic market. The country consequently experiences higher prices and lower output because industries are not allowed to achieve their potential production, given their available resources, while remaining profitable in the domestic economy.

Nevertheless, while it is clear that protection is harmful to the economy, the present industrial sector is characterized both by the lack of understanding of the economic costs of tariff. Hence, trade protection and the presence of powerful political-social forces strongly oppose any change in the status quo. This system of protection creates substantial rents to the producers of import-competing goods, to the importers that benefit from the allocation of (non-marketed) import rights, to organized labor that is sharing part of the monopoly rents resulting from the protection, and to the government bureaucracy that was administering the restrictive trade policies.

Trade liberalization through the EVSL increases the extent with which an individual industry can trade with other markets, providing better access to the markets particularly in ASEAN countries. This is particularly true for the sub-sectors that enjoy some competitive advantage. Moreover, as markets of other countries become more accessible, the probability of discovering other markets which used to be restricted become greater. In the domestic economy, the country also benefits as the entry of imported goods enlarges the consumer choices of cheaper products, like fish (Macam, et. al., 1998a) and food, thereby providing greater food security.

The classic argument against this type of trade liberalization under EVSL however is trade diversion. Trade diversion within sectors occurs when preferences are extended to a member country that is not the low-cost supplier. In this case, a stronger and perhaps more substantive version of the EVSL may induce new, but inefficient, trade flows. Not only will this be damaging to world welfare, it can also decrease the welfare of the country with these preferences (e.g., that country could have a negligible change in domestic prices, but lose the tariff revenue it obtained when it imported from the efficient supplier).

² The Most Favored Nation (MFN) principle refers to the principle embodied in Article I of the GATT whereby any privilege or concession granted by one contracting party to a product of another contracting party will be unconditionally granted to the like product of all other contracting parties.

Nevertheless, as countries become more varied, the likelihood of trade creation in regional agreement is expected to be greater than diversion. Economic integration will not be beneficial when trading partners have more substitutes than complements since having more substitutable goods restricts trade creation. APEC actually consists of sub-regional trading arrangements within it (e.g., AFTA, NAFTA, and CER). The formation then of a wider trading agreement, such as APEC, leads to a larger integration of economies that will make trade creation more conducive as more goods become available.

One way of checking whether the EVSL program is trade creating or trade diverting is to see the share of these sectors proposed to the nation's total exports and imports and its growth rate. If the share of imports is higher than the exports, then the EVSL can be trade creating since tariff reductions are expected to foster the availability of cheaper imports, while allowing exports easier access to the destination countries. If the country is heavily dependent on imports and if the exports are competitive, after controlling for the trade restrictions found in other countries, then the hypothesis taken that the EVSL is trade creating is valid.

Table 1 features the available data on the exports and imports of the EVSL sectors from 1994 to 1996. Three points are noteworthy. First, though the share of imports and exports for the individual sectors are negligible, the aggregate share tends to be substantial, thereby reflecting the significant effects that EVSL may have on the economy. Second, the share of imports of the sectors is roughly two times higher than the share of exports. Third, the rate of increase of imports for the said period is six times higher than the exports. Given that the APEC economies constitute a major share of these exports and imports (Austria, 1998), the EVSL program then presents an opportunity for these sectors to increase their productive capacity through imports and to obtain greater market shares for their exports.

The crucial assumption is that the sectors are export competitive in order to avail of these opportunities, or at the minimum that these products are close substitutes to those traded in the world market. Several authors have indicated that the EVSL is inadvisable because the industries are not competitive enough to survive the entry of cheaper foreign imports. Tariffs should then be maintained to allow industries time to become competitive. Experience however shows that the competitiveness is independent of tariffs. Table 2 shows the products that have consistently made it to the top 20 exportables of the country and the tariffs imposed on these same products.

Notice that all of these products have substantially lower tariffs now than in 1994 primarily due to the past and more recent tariff reforms. However, competitiveness is evidently not hampered as these products continue to dominate the other exported products. Though this table is meant to be illustrative than comprehensive, this clearly indicates that competitiveness is determined by factors other than tariffs. To some extent, the supply of these exports is dependent on the domestic policies that the government implements. In this case, the first-best intervention will be a set of subsidies with taxes designed to encourage the efficient industries and to discourage the inefficient ones (See Macam, et. al., 1998d, for the case of the fertilizer sector).

Another contention against the more aggressive type of trade liberalization is the potential losses in government revenues. While these revenues can be used to provide for income redistribution that can induce greater welfare as well as efficiency, the opportunity costs of the tariffs in the form of distortions can far outweigh the benefits to be gained. In particular, the probability of "immiserizing growth" can be increased in an environment of increasing liberalization where at the same time protected sectors are allowed to exist. As the country's growth gains momentum from the macroeconomic policies, the distortions arising from tariffs can be enhanced. The protected sectors can disproportionately draw greater amounts of resources away from the optimal allocation, thereby offsetting whatever positive effects of revenue redistribution.

Imposing import tariffs may nonetheless be advisable if the national economy desires to be self-sufficient in the production of certain resources. This means that the policy maker may wish to reduce the level of exports or imports below the optimal level determined by free trade. Since certain sectors, such as the wood or natural rubber industries, are still in the process of recovering their investments in regeneration, and since this requires a long gestation process, certain social gains can be derived by reducing consumption and production simultaneously, i.e., by achieving self-sufficiency (Macam et. al., 1998b,c). This self-sufficiency objective, or the decision to supply just enough goods for local consumption, can be attained by operating on both production and consumption of the importable good, since imports are the difference between consumption and production of the importable good, such as timber. In this case, tariffs have a distinct advantage because it exploits both ways of reducing imports, whereas taxes and subsidies would only capitalize on one route.

If society wishes to maximize the gains from trade, however, tariffs must be reduced for the finished products. A country, following world market prices, will then only export those goods that it produces more efficiently and import those commodities that cost more to produce. Hence, it is not necessary for countries to "level the playing field" in order to benefit from trade, as a number of analysts and industry representatives would claim. All that is required are differences in the terms of trade. If the country does not have comparative advantage on a particular commodity, or if the costs of exports are greater than the costs of the imports, then resources can be allocated more efficiently by producing other commodities and or simply importing such costly commodities.

In sum, the effects of the EVSL can be managed, depending on the kind of vision that society will have for the industries. On one hand, we can continue to take advantage of our natural resources and encourage self-sufficiency with our industries, especially the natural resources such as the wood products and rubber, mainly through reforestation investments. On the other hand, we can follow the example of Taiwan and Singapore, and transform the industries into efficient in-transit processors. If society chooses to pursue its export-promotion program aggressively, then the EVSL can be an important instrument.

IV. Does EVSL Hinder Multilateral Liberalization?

If the EVSL can be beneficial, then why did the initiative fail to generate enough support? We think that the EVSL has failed to prosper not because it is a hindrance to the country's multilateral liberalization process, but because the idea of multilateralism itself has not been totally accepted by the member countries. The Trade and Investment Liberalization and Facilitation (TILF) agenda of the APEC seemed to have overplayed the short-run agenda of EVSL, and in the process underplayed its long-term implications. Under this program, the officials have given the mandate to develop liberalization packages in nine sectors, and to undertake further work on six more sectors with a view of clearing the way for the development of liberalization packages in these sectors as well.

The main weakness of this program is the *ad hoc* selection of the 15 sectors, regarded by many to be largely a political strategy. This means that the identification of the sectors was made without any reference to any underlying economic framework or rationale. Nevertheless, the proponents of this program were considering the EVSL as a first phase of a broader trade liberalization process.

What seems acceptable to most member economies is a form of regionalism confined to limited number of sectors, and the EVSL experience itself reflects this tendency towards a circumscribed type of trade liberalization. Hence, the subsequent developments, starting from the choice of the fifteen sectors up to the agreements in the last economic leaders' meeting, can be seen primarily as a political process. In this environment, governments bargain internationally to get the best deal for their citizens, and at the same time raise an appropriate amount of benefits for a special interest or favored sector.

An alternative explanation to this turn of events is to think that voters decide on policies directly. In this situation, the kind of regional agreement that could do the least damage to the government would be those that will leave the median voter's utility unchanged by combining possible price shifts with product differentiation. Consequently, only a few sectors, if any, may likely be offered. This limiting situation can however be an equilibrium if partner countries possess capital-labor ratios different from the home country and when some improvement in utility can be gained by consumers (Levy, 1998). Such arrangements can be permanent, unless the welfare of swing voters is somehow undermined.

There are however two main problems with this political process. First, this renders the sectors to be offered more vulnerable to competition than those that were not selected. In effect, it penalizes the offered sectors, especially those producing finished goods. Consequently, this "piecemeal agenda" creates distortions especially if the inputs of the sectors chosen are excluded (Austria, 1998). For instance, fish is being considered for liberalization, while tinplates and other inputs are not (Macam, et. al., 1998a).

This problem actually extends globally. Bhagwati (1997, p. 73) has been often quoted thus:

"Is this free trade for APEC members to be for the members only, or is it to be on an MFN basis? If the former, then the only way for this to happen consistent with WTO,

is for APEC to seek to be a Free Trade Agreement (FTA) and to get Article XXIV³ exemption from MFN requirements, with all the damage that yet another gigantic FTA would impose on the multilateral trading system. If the latter, then there are distinct problems. It is hard to imagine that APEC countries would make more than token MFN reductions in their trade barriers without reciprocal concessions by non-APEC members.”

The key problem is that, in face of the Asian crisis, the countries may be hard-pressed to liberalize multilaterally those activities that are deemed strategic to the development. This is particularly true in the present crisis and especially so for Asian nations -- except the Philippines-- where trade with countries outside the APEC is as important as trade within the bloc (see, e.g., Haggard, 1995). Because of this free-rider problem, the option to limit tariff reductions to member countries only can be a sensible response. Thus, strong opposition within Asia to create a trading arrangement within the MFN mould as designed in APEC will be expected.

Second, this politically-driven process will more likely lead the sectors marked with having low trade barriers to be selected and offered first, resulting to the exclusion of the sectors that possess high protection. If the "easier" sectors are also those that have relatively low trade barriers, this will lead to a widening of the dispersion of protection levels across sectors in the APEC region, along with the decrease in economic efficiency (Scollay, 1998).

This can very well be seen in the case of the Philippines. Table 3 presents the effective protection rates (EPRs) of the EVSL sectors and the industries that recorded the highest EPRs in 1996 and 1997. Three points are important. First, those highly protected sectors are categorized as sensitive agricultural products which in some cases are also the inefficient ones (e.g., sugar milling and refining). Second, the average protection rate to the EVSL sectors is roughly 6 times lower than the selected industries, thereby showing the significant difference between the EVSL sectors and those sectors that need to be liberalized the most. Third, while these selected sectors on the average have experienced reduced protection rates in 1997, the rate of decline for the EVSL sectors is greater. This suggests the difficulty of liberalizing these heavily protected sectors as well as the discriminatory nature of this type of liberalization.

In a model with differentiated products and variety gains, the move towards multilateralism can be hampered. Without product-differentiation, consumers and producers comprising the median voters would easily opt for broader liberalization that results in lower prices with variety gains. However, in a product-differentiated setting, regional trading agreements, causing higher prices, can lead to welfare gains to the median voter once variety gains have been taken into account (Levy, 1998). In the process, if median voters were to decide the policies, only a few sectors, if ever, can be offered. While this may be favorable to a number of import-competing industries, it may be more difficult to liberalize particularly if these sectors had enjoyed some degree of protection for a number of years.

³ In Article XXIV, the GATT recognizes the value of closer integration of national economies through free trade as an exception to the general rule of most-favored-nation treatment, provided that the arrangements facilitate trade among the countries concerned without raising the barriers to trade with the outside world.

V. Policy Implications

In an increasingly globalizing environment, multilateral trade liberalization is preferred to any form of state intervention. However, once trade restrictions have been in place for a significant period of time, it is particularly difficult to remove them within a short period and almost impossible for all countries to remove such distortions simultaneously. In the short-run, there are three broad strategies to deal with the distortions: (i) the policy of minimizing the welfare costs of trade protection by using subsidy/tax instruments; (ii) unilateral trade reform where domestically imposed distortions are removed; and (iii) regional trade agreements where only member countries can be asked to reduce distortions simultaneously.

Regional trade agreements can lead to discriminatory policies and at worst hinder the multilateralism. Nevertheless, a case can be made to have a type of regionalism that aims to achieve multilateralism. Instead of analyzing these two components separately or sequentially (i.e., treating one to be exogenous and determining its implication for the other), understanding the interplay of these two components is more favorable (see Ethier, 1998). Moreover, policies on unilateralism and domestic interventions should be considered in relation to the overall economic system.

Several key policy points can be made from the discussion. First, products with regional trading arrangements should continue to have MFN status in order to avoid discriminatory policies from each member country. Second, for such trade agreements featuring MFN qualities to become multilateral, such negotiations must be extended to more sectors. Third, given that country's exports are uncompetitive or are not close substitutes to world market goods, this process of multilateralism will have to be accompanied by subsidies and taxes that enhance greater competitiveness and efficiency. Fourth, this development then can be accelerated by unilaterally reducing domestically imposed distortions. This will remove the distortionary and inefficient implications within the domestic economy resulting from the piecemeal approach that EVSL is adopting.

Regionalism offers the economies opportunities to explore gains not necessarily in terms of trade, but through facilitation, investments, and economic and technical cooperation. However, without domestic policies to improve efficiency and unilateralism to remove trade distortions in the domestic market, this will neither be productive nor efficient.

As evident from the EVSL experience, political factors come into play in the implementation of regional trade agreements. The APEC has generated a lot of publicity, but the presence of unalterable price distortions in several countries and the current Asian crisis prevent the realization of a more meaningful trade liberalization. In this light of these developments, the Philippines is advised to implement all three approaches--domestic policies, unilateralism and regionalism-- towards multilateralism.

Table 1. Share of APEC EVSL sectors to total Philippine exports and imports, and average annual growth rates, 1994-96.

	Share to Total Exports (%)			Growth Rate (%) 1994-96	Share to Total Imports (%)			Growth Rate (%) 1994-96
	1994	1995	1996		1994	1995	1996	
Toy	0.01	0.01	0.01	9.5	0.07	0.08	0.08	31.9
Environmental goods	0.03	0.03	0.03	15.9	2.09	2.07	2.33	32.8
Medical equipment and instruments	0.02	0.01	0.01	-6.4	1.06	0.93	1.04	24.7
Gems and jewelry	0.42	0.21	0.14	-28.6	0.01	0.01	0.01	5.1
Fish and fish products	3.84	2.8	2.04	-10.0	0.6	1.01	0.57	20.5
Forest products	4.31	3.75	3.31	8.1	2.27	2.82	2.72	34.9
Energy	1.20	1.09	1.18	24.5	15.17	14.02	14.13	21.4
Chemicals	1.51	1.29	1.09	6.6	14.9	13.63	12.04	13.1
Telecommunication equipment					4.08	4.74	5.04	37.0
Natural and synthetic rubber	0.10	0.16	0.16	57.6	0.13	0.12	0.11	-
Fertilizer	0.82	0.69	0.56	2.1	1.09	1.08	0.92	13.3
Automotive	4.58	3.96	3.89	13.5	4.83	5.33	5.48	31.2
Oilseeds and oilseeds	4.05	5.28	3.12	8.1	0.97	0.92	0.63	-0.4
Food	9.95	7.75	6.84	2.3	6.5	7.17	7.1	28.1
Civil aircraft	0	0.01	0	8.0	1.04	2.67	4.31	155.5
Total	30.84	27.05	22.38	5.7	54.69	56.48	56.4	37.0

Notes: - means negligible rate.

Source: Austria (1998).

Table 2. Nominal average tariff of top 20 Philippine exportables, 1994 to 1997 (in percent).

PSCC (3-digit level)	Description	1994	1995	1996	1997
36.1	Crustaceans (frozen)	60	30	26	26
37.1	Fish (prepared or preserved)	32	30	30	27.78
57.3	Bananas (including plantations)	50	50	30	30
58.9	Fruit, nuts and other edible parts of plants	35	30	30	24.06
334.1	Motor spirit (gasoline) and other light oils	20	20	7	5.22
422.3	Coconut (copra) oil and its fractions	50	50	30	30
682.1	Copper, refined and unrefined	3.93	3	3	3
752.6	Input or output storage units	3	3	3	3
764.1	Electrical apparatus for line telephone/ telegraphy	3	3	3	5.59
764.9	Parts and accessories	17.14	12.29	12.29	12.29
773.1	Insulated wire, cable	25.94	25.41	25.41	25.41
776.3	Diodes, transistors and similar semi-conductors	10	3	3	3
776.4	Electronic integrated circuits and microassemblies	10	3	3	3
784.3	Other parts and accessories of the motor vehicles	23.44	16.94	14.75	11.46
821.7	Furniture	35	30	30	30
845.1	Babies' garments and clothing accessories	30	30	30	20
894.4	Festive, or carnival or other entertainment articles	35	22.5	22.5	22.5
899.7	Basketware, wickerwork and other articles	27.65	25.56	25.56	25.92
931	Special transactions and commodities	20	13.17	12	18.92
971	Gold, non-monetary	7.9	3	3	3

Sources of basic data: Philippine Foreign Trade Statistics and Tariff and Customs Code, various years.

Table 3. Estimated effective protection rate (EPR) of EVSL products and selected sectors with the highest rates, 1996-1997 (in percent).

EVSL Products	1996	1997	Percentage Change
Civil Aircraft	2.30	2.47	7.28
Energy	3.44	2.61	-24.15
Environmental Goods	15.81	12.44	-21.33
Chemicals	13.72	10.68	-22.18
Fertilizer	2.30	2.33	1.68
Fish and Fish Products	10.63	9.97	-6.20
Forest Products	15.67	15.80	0.84
Food	17.43	9.05	-48.08
Gems and Jewelry	-1.09	-1.04	-3.77
Medical Equipment and Instruments	19.40	17.23	-11.19
Oilseeds and Oilseed Products	14.83	13.29	-10.35
Toys	11.26	12.25	8.79
Natural and Synthetic Rubber	15.96	15.30	-4.11
Average	11.20	10.12	-9.68
Selected Sectors with the highest EPRs			
Coffee Roasting and Processing	210.28	166.94	-20.61
Sugar Milling and Refining	105.92	84.72	-20.02
Meat and Meat Processing	93.09	86.30	-7.29
Manufacture of structural concrete products	80.52	50.73	-37.00
Coffee	64.60	51.64	-20.06
Manufacture of soap and detergents	62.07	62.35	0.46
Rice and Corn Milling	60.22	58.23	-3.30
Slaughtering and Meat Packing	58.07	36.84	-36.55
Manufacture of wire nails	55.54	56.45	1.66
Palay	53.14	53.15	0.02
Manufacture of metal containers	46.83	47.03	0.43
Manufacture of hardboard and particle board	45.48	45.54	0.13
Manufacture and repair of other furniture and fixtures	42.83	45.56	6.39
Sawmills and planing mills	42.55	42.58	0.05
Manufacture of flat glass	38.67	38.72	0.13
Manufacture of other fabricated wire and cable products	38.32	35.64	-6.99
Manufacture and repair of metal furniture and fixtures	37.50	39.48	5.29
Other agricultural production, n.e.c.	36.55	30.19	-17.40
Manufacture of Animal Feeds	35.44	34.07	-3.88
Noodles Manufacturing	34.19	35.79	4.68
Average	62.09	55.10	-7.69

Source of basic data: Philippine Tariff Commission

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