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Economic Integration in East Asia: A Philippine Perspective

Felipe M. Medalla

This essay starts from two premises: (1) growth in East Asia is beginning to draw more and more from the internal strengths of the more dynamic economies in the region, and (2) the benefits of economic integration will, at least initially, be unequally distributed. Initially, I wanted to look at East Asian economic integration from the point of view of all lagging economies in the region. Such, however, is beyond my competence. So, I decided to focus on what I think is a Philippine perspective.

China and Japan have good reasons for wanting to take the lead in fostering greater East Asian economic integration. The Philippines, on the other hand, has good reasons to be ambivalent about rising economic integration in the region. It gained much less than its more dynamic neighbors after it liberalized trade. It is hard to be optimistic that the Philippines will benefit more than neighboring countries from economic integration.

Yet, it cannot opt out, especially if nearly everyone opts in. It has tried the protectionist approach and failed. The so-called infant industries that the government chose to protect in the 1960s and the 1970s could not be weaned off of protection and the preferential allocation of credit and foreign exchange. There is no reason to repeat the failed import-substitution policies. The Philippines can only hope the rules that govern Asian economic integration will be flexible enough to give it room to handle its sensitive sectors. It can also hope that some integration will occur in Asian labor markets as well.

China and Japan as leaders in East Asian economic integration

Since the late 1990s, governments in East Asia have actively explored the possibility of free trade agreements (in the case of Japan, economic partnership agreements, EPAs). China and Japan have been the prime movers in pushing for agreements that would foster greater economic integration in the region. Japan has successfully negotiated an EPA with Singapore (Japan-Singapore Economic Partnership Agreement) and is almost certain to succeed in doing so with several other countries in the Association of Southeast Asian Nations (ASEAN) as well (for example, the Japan-Philippines Economic Partnership Agreement is expected to be signed before the end of 2006).

China and Japan each certainly have unique motives for wishing to foster greater economic integration in the region. However, they probably also share at least four reasons for this wish. The first is the desire to form a stronger front against possible discriminatory trade practices that may arise as a result of the formation of trading blocks in the West such as the European Union and the North American Free Trade Agreement. Another reason has to do with policy differences with the International Monetary Fund and the United States regarding global macroeconomic management that were highlighted by the Asian financial crisis. The third motive springs from the belief that economic cooperation based on geographical proximity may generate significant political and economic gains. The fourth and possibly the most important reason is the need to reduce dependence on the United States as a market for exports, given the fact that U.S. trade deficits are now large and would eventually have to be reduced by cutting into the growth of imports (by increasing protectionism, limiting economic growth, or depreciating the dollar). In short, these factors will result in changing the region "from a set of countries that rapidly integrated with the world to a region that is aggressively exploiting the sources of dynamism that lie within Asia" (Gill and Kharas 2006).

Japan is working hard to facilitate the formal economic integration of the region by trying to sign EPAs with the Republic of Korea and some ASEAN countries. As pointed out by Baldwin (2002), the pressure on ASEAN countries to enter into trade agreements with Japan will be hard to resist if a Japan-Korea agreement is forged. This is so since Japan is a major market for Malaysian and Thai exports, a significant portion of which may compete with Korean products. By the same reasoning, the pressure on Indonesia and the Philippines to sign an EPA with Japan would be magnified if Malaysia and Thailand sign EPAs with Japan.

Given its complicated relationship with Japan and the United States and its dynamic economy, China should be quite optimistic that it would benefit in political and economic terms from greater regional economic integration. For instance, at the ASEAN+3 (plus China, Japan, and Korea) meeting in 2000, China proposed the creation of an economic expert group that would look at ways to increase ASEAN-China cooperation, including the possibility of a free trade agreement not only with ASEAN, but with Japan as well.

For such a large country that still has an abundance of surplus labor, it is not healthy for China to be too dependent on European and U.S. markets. It is therefore not surprising that China's active pursuit of increased regional economic integration is reflected not only in official Chinese statements (including at the last meeting of the Board of Governors of the Asian Development Bank [ADB] in Hyderabad), but also by China's offer of an "early harvest," whereby cuts in tariffs on ASEAN exports to China would be granted appreciably ahead of the reciprocal grant of the same preferential treatment for Chinese exports by ASEAN member countries.

Ambivalence of countries such as the Philippines

Under traditional or standard trade models or theories, all countries stand to gain from free trade. Indeed, under the simplest version of the standard model, there is no obvious reason why peripheral economies should benefit less from freer trade than core or leading economies. In a world where learning by doing, agglomeration and scale economies, and endogenous technological progress determine the direction of trade and investment flows, however, lagging or peripheral countries may gain much less from trade in spite of the fact that the total dynamic gains from trade may be much bigger than the static gains (for example, those arising purely from differences in factor endowments).

So what is the advantage for lagging countries such as the Philippines? Unfortunately, the dynamic forces that drive rapid growth in core or leading countries may also be the same forces that reduce the growth prospects of the lagging countries, at least at the early stages. The free movement of goods and capital allows for greater agglomeration and scale economies, which, in the absence of congestion costs and labor shortages, tend to concentrate growth in a few places.

In contrast to international trade theory, which recognizes that trade tends to concentrate growth in a few countries only after the introduction of the "new economic geography," the literature on urban and regional economics has long held the view that, because of scale and agglomeration economies, trade in goods and the movement of labor and capital within countries tend to concentrate economic activity in a few central places unless congestion costs in the central places put a brake on this geographical concentration of economic activities. Indeed, the primacy of metropolitan centers in terms of their disproportionately large share in total population and gross domestic product (GDP) is testament to the fact that growth tends to be highly concentrated if not only goods, but also factors of production are mobile.

That growth is highly concentrated in the center, however, does not result in political pressure to restrict trade within countries not only because it is extremely difficult to control the movement of goods within countries, but also because most national tax and expenditure systems are designed to offset at least partially the effects of unbalanced growth. Moreover, people in backward areas may gain from increasing specialization and intracountry trade by migrating to the central places. In the Philippines, for example, the share of the National Capital Region in nonagricultural GDP (and, in all likelihood, in taxes as well) is around 42 percent, but the corresponding share of local governments in the National Capital Region in the block grants from the national treasury to local governments (called the internal revenue allotment) is only 8.1 percent. Moreover, the migration of workers to the richer regions of the country reduces interregional wage differentials and increases remittances to the poorer regions. Regrettably, in the case of international trade, an international tax system does not exist that would, at least partially, redistribute what is expected to be large, but highly unequal gains from trade, and there is not a sufficient movement of labor (because of the high cost of immigration and immigration controls) to reduce wage and income differentials.

It is therefore not surprising that lagging countries in Asia have ambivalent attitudes toward greater regional economic integration. The statement below of the alternate governor from Bangladesh (which is not part of East Asia) at the 39th meeting of the Board of Governors of the ADB perhaps best describes the ambivalence of governments in lagging economies toward greater economic integration in the region:

> The euphoria surrounding globalization seems to be waning as the champions of globalization have in recent times expressed doubts as to its effect on their industries and employment. We still believe in the process of globalization but at our own pace and convenience based on realities on the ground. (Zabihullah 2006: 2)

The above quotation stands in stark contrast with the statement made by China at the same meeting:

> ADB should further regional cooperation, a mission that is enshrined in the ADB Charter. Regional cooperation is full of potential. It is our hope that ADB will continue to play a role as a facilitator and financier. As a facilitator, ADB should give full play to its strengths as a multilateral institution and do more coordinating work, so as to promote deeper regional cooperation. (Jin 2006: 2)

The statement from the Philippine secretary of finance at the same meeting did not mention Asian economic integration at all and pinned Philippine hopes “on the successful conclusion of the Doha round” (Teves 2006). Unfortunately, the Doha Development Round has thus far failed to reach any agreement and probably never will, a fact that should be well known to the secretary of finance. Moreover, the benign view of the Philippine secretary of finance on the impact of a successful conclusion of the Doha round on the Philippines is not shared by many of his colleagues in the Department of Agriculture. In short, the way things are in the Philippines, there are mixed feelings about the failure of the Doha round. On the one hand, that many international trade issues are unresolved in the Doha round is a good thing from the point of view of government departments, the main constituencies of which are heavily protected by tariffs and trade barriers, to the extent that pressure on the Philippines to liberalize further is reduced. On the other hand, to the extent that the Philippines could have gained from a wider opening up of developed-country markets and from a significant reduction in agricultural subsidies in the developed countries, the failure of the Doha round is clearly bad for the Philippines. At any rate, those who publicly proclaim that it is a good thing that the Doha round failed far outnumber those who say otherwise. (For example, the title of an opinion piece by a long-time critic of trade liberalization was "Why Monday's Collapse of the Doha Round Negotiations is the Best Outcome for Developing Countries" [Bello 2006].)

Slow economic growth after trade liberalization

That the Philippines is not as sanguine as China, Malaysia, or Thailand about the implications of greater economic integration in the region is hardly surprising if one has looked at how the Philippine economy has performed since the second half of the 1980s, when international trade started to be significantly liberalized (beginning with the administration of President Corazon Aquino). As shown in table 12.1, the Philippine economy has lagged behind high-performing Asian economies. With the exception of the last five years, when the Philippines had the third lowest growth rate among the countries shown in the table, per capita GDP growth has been, by far, the lowest in the Philippines during the last two or three decades among the Asian countries in the table. Moreover, the Philippine economy actually grew more rapidly during the import-substitution and protectionist decades of the 1960s and the 1970s (not shown in the table) than over the last 20 years.

TABLE 12.1. Average Annual Per Capita GDP Growth in Selected Asian Countries
percent

Country	*1981–90*	*1991–2000*	*2001–04*
China	7.7	9.1	8.1
Korea, Rep. of	7.4	5.3	4.1
Indonesia	3.5	2.5	3.3
Malaysia	3.3	4.5	2.1
Philippines	−0.6	0.7	2.2
Singapore	4.8	4.8	1.4
Thailand	6.1	3.5	4.3
Vietnam	—	5.8	5.9

Source: Compiled by the author based on data from the ADB (www.adb.org) and the International Monetary Fund (www.imfstatistics.org).
Note: — = no data are available.

Weak influence of the export sector on Philippine trade policy

In general, a country's trade and industrial policy and the resulting level and structure of trade and nontariff barriers balance the political costs and benefits involved in opening up the economy (as perceived by policy makers). Domestic producers (and their labor unions) who are threatened by cheaper imports lobby for high-tariff protection and trade barriers. On the other hand, consumers are not seen by politicians as an interest group, so exporters may be the only ones who have some interest in lobbying for a more open economy. Exporters, however, will generally not lobby against tariffs or trade barriers that do not directly affect them (although they are indirectly affected to the extent that the trade barriers affect the real exchange rate) and may be placated by exempting their inputs from tariffs and domestic taxes (through bonded customs warehouses or tax and duty drawbacks). Thus, unlike in the case of Chile, tariffs are unlikely to become either uniform or low. Some sectors will receive much higher-than-average protection from foreign competition, and exports will be promoted not by reducing tariffs and trade barriers, but by giving exporters fiscal incentives and waivers of taxes and duties on their imports of raw materials and capital goods.

Since the administration of President Aquino, the Philippine government has unilaterally reduced many tariffs and trade barriers so as to promote consumer interest (partly because they have believed it would result in lower inflation). However, in cases where there has been strong producer, worker, or peasant resistance, the government has often yielded to political pressure and given much higher-than-average protection to certain industries and sensitive agricultural products. For instance, the rates of protection for rice, sugar, motor vehicles, and petrochemicals remain high after two decades of trade and tariff reforms.

In theory, negotiations on free trade areas (FTAs) and EPAs change the political balance in favor of making the economy more open. This is so since negotiations that eventually lead to FTAs or EPAs make it very clear to exporters that they must lobby for the opening up of their country's markets to imports in order to win market access abroad for their exports.

One can argue that FTA and EPA negotiations could give Philippine political leaders greater fortitude to resist lobbying by groups that benefit from the few remaining protected segments (albeit relatively large ones) in the manufacturing and agricultural sectors. Exporters, who normally worry mostly about their input costs and tax incentives, will generally not lobby for opening up domestic markets to foreign competition unless such is the explicit price their government must pay to open up markets abroad for the exporters. The dilemma for Philippine leaders is that there is relatively weak support for free trade agreements because exporters in the manufacturing sector account for a relatively small share of GDP and employment. Moreover, firms that account for a large share of manufactured exports have succeeded, in spite of the existing system of protection, either because they are in duty- and tax-free enclaves and serve niche markets (for example, semiconductors) or are already well served by existing agreements (such as exports of textiles and garments prior to the termination of export quotas under the international Multifiber Agreement or exports of motor vehicle units and parts under the Japan-led ASEAN complementation scheme). On the other hand, the opposition is strong and well-organized. (Though small relative to the total population, it is able to coordinate large demonstrations and rallies.) To make matters worse, the academic and intellectual critics of greater economic integration never fail to point out that economic growth has been rather slow since the economy was liberalized. Sadly, export growth rates in the Philippines, although not nominally lower than those in other Asian countries except China, have not contributed significantly to the creation of jobs. Moreover, export growth has decelerated in recent years because of its dependence on growth in the demand for semiconductors (see table 12.2).

In spite of the modest growth in Philippine exports, growth in employment in the country's tradable sectors (manufacturing and agriculture) has been much lower than the growth rate of the labor force. The average growth rate of manufacturing employment during the last 10 years was only 1.6 percent. In the primary sector (agriculture, forest products, fishing, and mining), the growth rate of employment was even lower (0.5 percent). Much of the employment growth has occurred in the service sector (the great bulk of which is internationally nontradable), wherein employment grew by more than 4 percent. This has resulted in a decline in the employment share not only of the primary sectors, but of the manufacturing sector as well. The primary sector's employment share fell from 43.8 percent in 1995 to 36.4 percent in 2005. On the other hand, the manufacturing sector's employment share fell from an already low 10.2 percent in 1995 to 9.5 percent in 2005, which is a continuation of a long-term declining trend since the share of the manufacturing sector in total employment was more than 12 percent before international trade was liberalized. In short, the employment shares of the tradable sectors declined after the domestic economy became more integrated with the global economy.

TABLE 12.2. Export Growth Rates in Selected Asian Countries
percent

Year	*Indonesia*	*Malaysia*	*Philippines*	*China*	*Korea, Rep. of*	*Singapore*	*Thailand*
2005	19.5	—	—	28.4	12.2	18.8	15.0
2004	17.2	20.5	9.5	35.4	31.0	24.6	21.6
2003	6.8	11.6	2.9	34.7	19.3	15.2	18.2
2002	1.5	6.9	9.5	22.1	8.0	2.8	4.8
2001	−9.3	−10.4	−15.6	7.0	−12.7	−11.6	−7.1
2000	27.7	16.2	8.7	27.9	19.9	20.1	19.5
1999	−0.4	15.3	18.8	6.1	8.6	4.3	7.4
1998	−8.6	−6.9	16.9	0.5	−2.8	−11.9	−6.8
1997	7.3	0.6	22.8	21.0	5.0	−0.1	3.8
1996	9.7	6.0	17.7	1.5	3.7	5.7	−1.9
1995	13.4	25.6	29.4	23.0	30.3	−22.2	24.8
1994	8.8	24.9	18.5	31.9	16.8	30.9	22.2
1993	8.4	15.6	15.8	8.0	7.3	16.6	13.4
1992	16.6	18.7	11.1	—	6.6	7.6	13.8
1991	13.5	16.5	8.0	—	10.5	11.8	—
Average	8.8	11.5	12.4	19.0	10.9	10.5	10.4

Source: Compiled by the author based on data from the ADB Asia Regional Information Center (http://aric.adb.org).
Note: — = no data are available.

That employment growth in manufacturing was very disappointing despite modest export growth may be explained by the fact that much of the export growth is accounted for by only two types of goods: semiconductors and motor vehicle units and parts (including wiring harnesses). As shown in table 12.3, "electronic and electrical equipment and parts" and "machinery and transport equipment" are the two most rapidly growing exports, accounting for 82.6 percent of the increase in Philippine exports (in U.S. dollars) during the last 20 years. Former mainstays in labor-intensive exports—garments, textiles, and footwear—and primary exports performed poorly. Unfortunately, semiconductors and wiring harnesses have relatively low domestic value added and are less labor intensive than garments, textiles, and footwear. At any rate, trade and employment data will not inspire political leaders to open up the economy. Moreover, because the rise in the exports of electronic and electrical goods occurs largely in enclaves and because the rise in the export of automobile units and parts is not due to free trade, but to managed trade, it is not clear that joining FTAs would be good for employment growth. In short, the claim that freer trade will create a lot more jobs for the Philippines will be met with quite a bit of skepticism. (The Philippines restricted and heavily taxed the imports of completely built vehicles, while taxing the importation of car parts by car assemblers at a much lower rate. This fostered a very inefficient car assembly industry. Exports of cars and car parts rose after the sector was rationalized and became more efficient. This occurred when the government began allowing car companies to import completely built vehicles provided such imports are financed by exports of vehicles and vehicle parts. The tariffs are low if the automobile company is a participant in the ASEAN automobile complementation scheme.)

TABLE 12.3. Growth in Philippine Exports

Sector	*1985 (US$ millions)*	*2005 (US$ millions)*	*Increase (US$ millions)*	*Share in increase (%)*	*Growth rate (%, compounded)*
Primary sectors	2,038	3,441	1,403	4.0	2.6
Electronic and electrical equipment and parts	1,056	28,476	27,420	77.5	16.5
Machinery and transport equipment	30	1,836	1,806	5.1	20.6
Garments, textiles, and footwear	711	2,568	1,857	5.2	6.4
Other manufactured goods	1,007	3,910	2,903	8.2	6.8
Total	4,842	40,231	35,389	100.0	10.6

Source: Compiled by the author based on data from the Bangko Sentral ng Pilipinas (http://www.bsp.gov.ph).

Why there is little support for more trade liberalization

Supporters of trade liberalization argue, of course, that economic and employment growth is low *in spite* of trade liberalization. Such arguments, though plausible, may not gain ground with the general public, especially since many of the people who fought in favor of trade liberalization (for example, during the debates regarding Philippine membership in the World Trade Organization) also virtually predicted that it would result in much higher output and employment growth. Regrettably, actual employment and export growth did not come anywhere near the vision that supporters of trade liberalization painted during the debates that eventually led the Philippine senate to ratify the membership of the Philippines in the World Trade Organization.

At any rate, it is very hard to sell to opinion makers and policy makers the argument that people may not be much more well off today compared to the past, but have actually benefited from liberalization because they might have been much less well off if the economy had not been liberalized. In the first place, such an argument requires counterfactual reasoning (comparing what actually happened to the economy to something that did not happen and is therefore hard to visualize). In the second place, it requires that alternative explanations be given for the economy’s poor performance (such as external shocks, weak institutions, the absence of population policies, corruption, poor fiscal management, labor market distortions, poor infrastructure, mismanagement of the electricity sector, and so on). However, to the layman or even the typical legislator, the simplistic argument is much easier to follow: the economy did not perform well after liberalization; therefore liberalizing the economy was not a good idea, and it is not a good idea to liberalize further.

There are, of course, obvious gains from liberalization. Consumers certainly get much greater value for their money (in terms of quality and price) because of trade liberalization. The price of air conditioners today, for example, is about the same as it was 10 years ago despite a significant rise in the general price level and the continuous fall of the Philippine peso. Electronic products (for instance, DVD players and computers) have become more affordable, and cheap imported manufactured goods from China have expanded the consumption space of most Filipinos. What best illustrates the gains of consumers is the great number of people going to the shopping centers in Manila's Chinatown that sell virtually nothing except cheap Chinese goods. Unfortunately, policy debates about opening up the economy are never won by pointing out that cheaper, higher-quality imported goods are beneficial for the people. Indeed, to most politicians, cheap imported goods are good only if they do not compete with more expensive domestic products. (Recall the fallacy that, if it is true that exports increase employment, it must also be true that imports reduce employment.) At any rate, closures of uncompetitive factories are a lot more newsworthy than the increased supply of imported products that are cheaper or better. Moreover, among influential religious leaders whose encouragement might have given the politicians some backbone to support greater liberalization, the expansion of the consumption space was, in fact, seen as a bad thing (that is, negatively described as encouraging materialism and commercialism). Of course, the critics of liberalization would have dwindled if liberalization had also created a lot of jobs and not only increased the range and supply of higher-quality, lower-priced products.

However, neither employment statistics nor modern trade theory bears out that this is what happens. Indeed, what happened to the Philippines relative to high-performing Asian economies and Metro-Manila relative to the rest of the Philippines is quite consistent with the new economic geography that predicts some places will tend to grow much more rapidly than others (because of the dynamics of trade and growth, which are triggered by location-specific advantages such as governance, centrality, the size of the domestic market, and so on). Regrettably, Manila and its surrounding regions (Bulacan and Pampanga to the north and Laguna, Batangas, and Cavite to the south) are part of the periphery from the point of view of Asia and the world and are, at the same time, the center from the point of view of the rest of the Philippines. Thus, the Philippines has the worst of both worlds: slow economic growth that is overly concentrated in and around Metro-Manila.

One may, of course, again use the counterfactual argument that the continuation of import-substitution policies and protectionism as practiced until the early part of the 1980s would not have succeeded in making the Philippines a leading economy. This is so since the infant industries that were protected and promoted used a lot of imported inputs and did not become more efficient. They were therefore unable to export even after extended periods of protection. As a result, balance of payments shocks often resulted in increased idle capacity and layoffs. Typically, plants become underutilized when foreign exchange becomes scarce because balance of payments crises usually force central banks to reduce aggregate demand. Since the protected firms survive only because domestic prices are higher than border prices, the protected industries could not eliminate idle capacity by exporting what could not be sold domestically. In short, protectionism worsened the boom-bust cycles. The economy grew rapidly as long as the protected sector had access to cheap foreign exchange (for instance, because of war damage payments by Japan and the United States after World War II and because of foreign borrowing by the government during the administration of President Marcos), but collapsed when foreign exchange became scarce. In turn, balance of payments crises were almost periodic and inevitable because protectionism, which made foreign exchange artificially cheap for protected industries, also discouraged exports.

This was not initially the case in the early stage of import substitution when there were plenty of opportunities for easy import substitution. There were many industries in the 1950s and the 1960s that were otherwise globally competitive, but could not compete with imports because the peso was overvalued. (The official exchange rate was twice the black market rate.) There were two ways to level the playing field for such industries. One was to scrap import controls and devalue the peso. Another was to use foreign exchange, capital rationing, and selectively high tariffs to encourage import substitution. The government chose the latter, with initially encouraging results in terms of output and employment growth. (Some older Philippine economists still look at the early import-substitution period as a sort of golden age for manufacturing.)

However, as opportunities for easy import substitution were exhausted, policy makers chose to allocate resources to industries that were uncompetitive and used a lot of imported inputs. Unfortunately, none or very few of these capital-intensive infant industries became competitive. In short, with the exception perhaps of a few professional economists in government, Philippine policy makers abandoned important substitution and protectionism not because they liked trade liberalization. They did so because the Philippine import-substitution path had reached a dead end. This essay will not attempt to explain why protectionism did not become a springboard for export-led development in the Philippines, unlike the Japanese and Korean experience. (The top four explanations are weak bureaucracy, traditional politics, the rapacity of Philippine elites, and the backwardness of science and engineering, not necessarily in that order.) What is important to note is that Philippine policy makers, on the whole, were quite wary and uncomfortable with opening up domestic markets to foreign competition and opened up the economy only after they had failed in their attempts to achieve high and sustainable economic growth through interventionist trade and industrial policies. In other words, if one scratches the surface of a seemingly market-friendly policy maker hard enough, one is likely to find a protectionist who happens not to trust government. Thus, it is ironic that Philippine tariffs on many manufactured products were raised back to 1997-levels in 2003, after many years of gradual decline, under a president with a doctorate in economics.

In hindsight, the weak commitment to opening up the economy is not surprising. Liberalization did not usher in higher economic growth. It was accompanied by a fall in the share of manufacturing in total employment, and exporter and consumer lobbies were much weaker than the lobbies of the sectors that would be hurt by liberalization. It is therefore quite likely that trade liberalization in the Philippines cannot progress further. What was politically easy to liberalize has already been liberalized. What remains untouched by trade liberalization is the politically most difficult sectors. For instance, there are large potential gains from liberalizing the importation of rice and sugar (given the large difference between border and domestic prices). The sugar lobby is a shadow of its former self, but is still influential when it comes to sugar-importation policy. In the case of rice, on the other hand, the government is torn between greater economic efficiency and protecting rice farmers (who are, on average, poorer than urban rice consumers, and their plight has historical links with the communist insurgency).

Unfortunately, the government does not have the capability to tax the winners and compensate the losers from trade liberalization. Moreover, weak as the tax system is, it is much stronger and less corruptible than the system of making transfer payments or subsidies. There is plenty of anecdotal evidence that, whenever the government gives money to people who are hurt by policy change or natural calamities, the likelihood that many nonvictims will be toward the front of the queue is quite high. In short, the capacity to supply targeted subsidies may be even weaker than the capacity to administer taxes.

The case of sugar is a different story. A fall in the price of sugar may actually reduce agricultural land prices and make agrarian reform more affordable (since land reform is based on the principle of just compensation). The sugar lobby is not as strong as it used to be. In the past, it was a kingmaker not only in local politics, but in national politics as well. (It was often said that one could not be president of the Philippines without being anointed by the sugar bloc.) However, it remains politically influential in many provinces. Moreover, access to the U.S. markets that is protected by a system of sugar-import quotas actually makes it worthwhile for the Philippines to import sugar for domestic consumption and produce sugar for the U.S. markets, which creates a lot of opportunities for rent seeking.

The Philippines gains largely from consumption and the export of labor

It is worth noting that a significant part of the gains from integrating the Philippine economy with the global economy is accounted for by migration (both circular and permanent) by Philippine workers. At constant 1985 prices, Philippine per capita income increased by US$186, from US$631 to US$817. In contrast, remittances per capita increased by US$51 during the same period, which represents more than a quarter (27 percent) of the increase in per capita income from 1995 to 2005.

In current prices, the share of remittances in the increase in per capita income is even greater (see table 12.4). Per capita income increased by US$139, from US$1,085 in 1995 to US$1,224 in 2005. On the other hand, the increase in remittances per capita during the same period was US$69, or one half the increase in per capita income.

TABLE 12.4. Share of Worker Remittances and Two Key Exports in Per Capita GNP

Year	*Per capita GNP*[a]	*Remittances per capita*	*Valued added in electronic and electrical equipment exports per capita*[b]
Constant 1985 prices			
2005 (US$)	817	83	44
1995 (US$)	631	32	12
Increase (US$)	186	51	32
% of total increase	(100)	(27)	(17)
Current prices			
2005 (US$)	1,224	124	66
1995 (US$)	1,085	55	21
Increase (US$)	139	69	45
% of total increase	(100)	(50)	(33)

Source: Compiled by the author based on data from the Bangko Sentral ng Pilipinas (http://www.bsp.gov.ph).

a. GNP = gross national product.

b. Assumed to be equal to 20 percent of total exports of electronic and electrical equipment.

Since there was a large real depreciation of the peso after the Asian financial crisis and a large proportion of gross national product (GNP) is nontradable, it is possible that the importance of increases in worker remittances would be overstated if one uses current prices and exchange rates to compare the peso value of domestic production with the dollar value of worker remittances. Moreover, remittances may have negative effects on the international competitiveness of tradable sectors in the Philippines (via the Dutch Disease effect through the exchange rate). However, using 1985 prices to compare 2005 and 1995 values is also quite problematic. In addition, worker remittances may have large multiplier effects to the extent that many sectors of the economy use imported inputs. For example, transportation and distribution costs and the markups of wholesalers and retailers are counted as value added when imported goods are sold to consumers. (Thus, the valued added of the wholesale retail sector in 2005 was 70 percent of the value added of the manufacturing sector, up from 55 percent in 1990.) At any rate, whether increases in remittances account for one-quarter or one-half of the increase in per capita incomes, it is clear that, relative to other countries, Filipinos benefited much more from the integration of global labor and goods markets than from the integration of global production.

Table 12.5 shows the distribution of worker remittances by geographical origin. The United States was by far the largest source, accounting for 60 percent of the remittances in 2005. Europe and the Middle East each accounted for 13 percent, and Asia accounted for 11 percent. Nearly a million overseas workers were reported to have been deployed in 2005. The deployment statistics of the Department of Labor and Employment do not include the bulk of the 1.4 million to 1.6 million Filipinos in the United States who generally do not register with the department when they leave the Philippines. This probably explains why the United States is the biggest source of remittances. Still, it may be that the share of the United States in remittances is overstated since permanent migrants are expected to remit less than circular migrants. One possible reason for the overstatement of the share of the United States in remittances is that remittances from other countries that go through U.S. banks may sometimes be reported as remittances from the United States.

TABLE 12.5. Worker Remittances, by Source
US$ thousands

Year	*Total*	*United States*	*Asia*	*Europe*	*Middle East*	*Other*
1997	5,741,835	4,109,430	454,791	436,050	25,375	716,189
1998	7,367,989	6,403,215	401,419	329,317	60,682	173,356
1999	6,794,550	4,868,879	645,566	457,671	263,004	559,430
2000	6,050,450	3,944,639	831,779	534,675	594,198	145,159
2001	6,031,271	3,202,230	1,049,551	406,194	711,918	661,378
2002	6,886,156	3,443,547	1,116,336	889,094	1,242,809	194,370
2003	7,578,458	4,299,850	894,310	1,040,562	1,166,376	177,360
2004	8,550,371	4,904,302	918,329	1,286,130	1,232,069	209,541
2005	10,689,005	6,424,848	1,172,373	1,433,904	1,417,491	240,389

Source: Compiled by the author based on data from the Bangko Sentral ng Pilipinas (http://www.bsp.gov.ph).

Exports of electronic and electrical equipment accounted for much more than 80 percent of the increase in Philippine exports. If it is assumed that valued added is 20 percent of the value of the top export, this value added would account for 17 percent of the increase in per capita GNP between 1995 and 2005 at 1985 prices and 33 percent at current prices (see table 12.4).

Combined with the increase in remittances, this sums to 44 percent of the increase in per capita GNP in constant prices over the last 10 years and an incredible 83 percent of the increase in per capita GNP in current prices.

As shown in table 12.6, the rest of the manufacturing sector did not do as well as the production of electronic goods and electrical parts and equipment. The rest of the manufacturing sector's share in GDP declined from slightly less than a quarter in 1991 to 21.1 percent in 2005. Why the production of electronic and electrical equipment and parts showed a totally different trend from the rest of manufacturing is perhaps worth a short digression.

TABLE 12.6. Share of Traditional Manufacturing in GDP

	GDP	*Value added in traditional manufacturing*[a]	
Year	*(constant 1985 ₱ millions)*	*Constant 1985 ₱ millions*	*Share of GDP (%)*
1991	717,225	176,829	24.7
1993	712,332	173,787	24.4
1995	766,368	179,723	23.5
1997	849,121	200,746	23.6
1999	888,075	201,867	22.7
2001	958,411	209,593	21.9
2003	1,023,101	218,054	21.3
2005	1,134,907	239,818	21.1

Source: Compiled by the author.

a. Excluding electronic and electrical equipment and parts.

Many parts of Philippine manufacturing were not globally competitive and were therefore unable to prosper when the level of protection from foreign competition was reduced. Electronic and electrical parts and equipment, on the other hand, are produced almost exclusively for export by subcontractors or wholly owned plants of multinational companies. European (for example, Philips), Japanese (such as Fujitsu, Hitachi, NEC, and Toshiba), Korean (for example, LG and Samsung), and U.S. firms (such as Intel and Texas Instruments) probably have very different motives for investing in the Philippines. U.S. electronics firms have been in the Philippines for more than two decades. They operate plants that have direct production links with the mother companies and are not part of an Asian or ASEAN regional production network. (For instance, according to one news report, the payroll of Texas Instruments in Baguio is prepared and electronically transmitted directly at the U.S. headquarters.) Some of the plants that are affiliated with ASEAN firms, on the other hand, are part of a regional production network. Perhaps the best example of the importance of a regional network would be Malaysian- or Singaporean-owned firms in the Philippines that are part of the same regional production network as the Malaysian or Singaporean principals.

Japanese multinational corporations, on the other hand, may have different reasons for being in the Philippines relative to corporations from an ASEAN country. Unlike their European or U.S. counterparts, which are mostly involved in assembly and testing, Japanese electronics firms are producing a wide range of products (semiconductors, hard disk drives [HDDs], automobile wiring harnesses, smart automobile brake systems, and so on) in the Philippines. Their activities have relied on various modes of structure and operation, ranging from wholly Filipino-owned subcontractors to wholly owned subsidiaries in the Philippines. For instance, the HDD industry in the Philippines is dominated by Japanese-owned assemblers and suppliers that belong to the *keiretsu* (industrial groups) of the firms or their Japanese independent contractors. (In contrast, among non-Japanese firms, only Read-Rite, Inc. and Seagate are present in the Philippines, and most U.S. HDD firms established in Malaysia, Singapore, and Thailand have not located in the Philippines.)

The wave of Japanese investments in electronics in the Philippines to a great extent was part of the Japanese expansion into Southeast Asia. With the strengthening of the yen (the high yen, or *endaka*), intense global competition induced Japanese firms to transfer separable production to countries with lower production costs. The case of HDDs, however, was quite unique since most Japanese firms that located assembly operations in the Philippines did not locate similar facilities anywhere else outside Japan. Agglomeration economies probably explain why the assembly of HDDs by Japanese firms was highly concentrated in the Philippines. Still, the firms could have located their operations in another ASEAN country, but a combination of factors, including proximity to Japan (so that Japanese managers may make frequent plant visits) and a good supply of engineers and English-speaking workers (the firms hire only workers with at least two years of college), made the Philippines the preferred (or, in the case of three of the four Japanese HDD firms, the sole) plant location outside Japan. The importance of the ability of workers to speak English to Japanese managers is not surprising since Japanese managers who were working outside Japan generally spoke English and no other foreign language. If a good supply of educated English-speaking workers was important to Japanese firms, it is not far-fetched that it would be at least equally important to European and U.S. firms. (Surprisingly, this is not as well documented since more studies have been conducted on the motives of Japanese firms for locating in the Philippines.)

Why the Philippines is still in the game

Given that much of the gain of the Philippines in becoming integrated with the global economy has arisen from exports of labor (and the imported goods that this financed) and from exports of electronic and electrical equipment, one could argue that the Philippines could have done equally as well if it had not liberalized trade. This is so since it may well be that exports of labor and electronic and electrical equipment would have increased even if trade had not been liberalized. What promoted exports of electronic and electrical equipment and parts was their exemption from taxes and duties on raw materials and capital equipment. The exemptions were carried out through bonded customs warehouses and duty drawbacks, two incentives that could be offered to exporters independently of the level of protection that is given to domestic industries. In short, very little of the growth in Philippine current account receipts (in the balance of payments) could be attributed to trade liberalization. This fits the pattern for lagging countries in the new economic geography.

Does this mean that there is a high risk that the Philippines would resist free trade agreements or even reverse liberalization? The Philippines did, in fact, raise some tariffs back to 1997-levels in 2003. However, no other, similar reversals have occurred since then. It is, of course, very hard to forecast what politicians will do, but it is probably safe to say that the liberalization will not be reversed. In the first place, protectionism will be driven by the lobbying efforts of uncompetitive sectors of the economy, not by explicit industrial policy.

But the fact that the share of manufacturing in total employment has declined to less than 10 percent (even lower if one does not treat a big part of food processing, such as rice milling, as manufacturing) means that much of what remains in the manufacturing sector is either export oriented or inward looking, but competitive. Moreover, the fact that many people expect smuggling to rise if trade barriers and tariffs are raised means there is only a weak political constituency for raising tariffs. Finally, overseas workers have become a powerful political constituency that would like to get good consumer value for their hard-earned money. For instance, they are allowed to bring home a significant amount of imported goods tax and duty free when they return. (This, in turn, has resulted in the proliferation of duty-free shops that cater not to tourists, but to overseas workers and their families.)

Another factor that militates against a reversal of trade liberalization is widespread skepticism that industrial policies successfully practiced (or perceived to have been practiced successfully) in Japan and Korea will work in the Philippines. In short, Filipinos may not have much faith in globalization and the market, but they distrust the government's ability to pick winners even more.

That the current levels of protection will not be raised is, of course, not the same thing as saying that the Philippines could be easily convinced to join FTAs. The Philippines joined the ASEAN Free Trade Area (AFTA), but there was virtually no visible opposition to AFTA membership, which is a reflection more of the flexibility of AFTA (with regard to the exclusion of sensitive products, for example) than of the willingness of the Philippines to join FTAs. In short, given the low political cost of joining AFTA, being excluded from it was unacceptable. Philippine political and business leaders correctly perceive that the cost to the Philippines of being left out of an FTA would be higher, the larger the number of Asian countries joining FTAs.

The prospects for a Japan-Philippine EPA

Like AFTA, an EPA with Japan is also likely to be perceived as uncontroversial in the Philippines. Given Japan's reluctance to reduce agricultural protection, it is unlikely to ask for free trade in agricultural products. Indeed, the fact that the Philippines is a net importer of rice is probably one of the reasons why Japan chose to have an EPA with the Philippines ahead of all other ASEAN countries except Singapore. That the Japanese are seeking many exceptions for agricultural products does not seem to be a stumbling block from the point of view of Philippine policy makers. In the first place, the Philippines is not a major exporter of agricultural products. In the second place, exports of high-value agricultural goods to Japan would be relaxed during the Japanese off-season. Off-season exports may not be good enough from the point of view of some Philippine producers of high-value agricultural products (such as tropical fruits) who see Japan as a large potential market, but their objections would carry little political weight, especially if Japan offers to expand official development assistance (ODA) loans for infrastructure and agrees to open up its labor markets to nurses and caregivers. Indeed, the biggest concern on the Philippine side in the negotiations with Japan is not the number of products that Japan wants to exclude from the trade agreement, but the number of Philippine nurses and caregivers that Japan is willing to accept. President Arroyo personally communicated this point during her last visit to Japan. The Japanese response, however, was rather cautious (because of strong objections from Japanese health care workers). They offered to allow entry of only 100 nurses. The Philippines would probably accept the Japanese offer in the hope that the entry of 100 nurses might pave the way for a greater deployment of Philippine nurses and caregivers in Japan later.

Finally, the reduction of tariffs on Japanese exports of manufactured goods to the Philippines is not a major concern on the part of the latter. Philippine tariffs on manufactured goods are already quite low. The manufactured goods that will be covered by the Japan-Philippine EPA are also subject to zero or low duties for imports covered by the AFTA. The Philippine automotive industry would probably be most affected by the Japan-Philippine EPA. The Philippine motor vehicle assembly and parts industries, however, are mostly owned by Japanese firms and are not going to object to including motor vehicles in the Japan-Philippine EPA. (Not surprisingly, Ford Philippines was not keen on the idea of including cars in the agreement, but its objections are unlikely to deter the Philippines from signing an EPA with Japan.)

China and the Philippines

A free trade agreement that includes China (through a bilateral agreement or through ASEAN) would probably immediately garner negative reactions from most politicians and businessmen in the Philippines. The image of a juggernaut hollowing out the manufacturing sector in the Philippines comes to mind. Yet, more and more Philippine businessmen are beginning to look at China as a market rather than as a competitor. Indeed, as shown in table 12.7, exports to China are the most rapidly growing area of Philippine exports, surpassing exports to Korea in 2002 and almost matching exports to all ASEAN countries in 2005.

TABLE 12.7. Philippine Exports, by Recipient
US$ millions

Year	*United States*	*Europe*	*Japan*	*China*	*Korea, Rep. of*	*ASEAN*	*Total*
1994	5,143	2,428	2,024	164	292	723	13,483
1995	6,160	3,134	2,742	214	444	1,370	17,447
1996	6,966	3,684	3,668	328	371	1,742	20,543
1997	8,815	4,670	4,192	244	474	1,809	25,228
1998	10,098	6,139	4,233	343	510	1,987	29,496
1999	10,445	6,969	4,660	575	1,032	2,512	35,037
2000	11,365	6,991	5,606	663	1,173	2,845	38,078
2001	8,979	6,349	5,054	793	1,044	2,669	32,150
2002	8,683	6,567	5,292	1,356	1,339	3,047	35,208
2003	7,119	6,086	5,756	2,143	1,311	4,003	35,752
2004	7,088	6,895	7,981	2,653	1,113	4,195	39,681
2005	7,402	7,116	7,202	4,077	1,391	4,424	41,221

Source: Compiled by the author based on data from the Bangko Sentral ng Pilipinas (http://www.bsp.gov.ph).

Moreover, Europe and the United States account for a big chunk of Philippine exports, which would be threatened by competition from China whether or not ASEAN or the Philippines has a free trade agreement with China. Thus, competition from China has already resulted in slower growth in the exports of Philippine garments. A similar fate probably awaits Philippine exports of electronic and electrical products to Europe and the United States as electronics products become standardized commodities. In other words, because of 20 years of trade liberalization, which has reduced the relative share of the vulnerable part of Philippine manufacturing in total employment, there is not much left in the Philippine manufacturing sector that may be threatened by greater East Asian economic integration.

This is not to say that no segment of Philippine manufacturing will be less well off if tariffs and trade barriers between China and the Philippines are significantly reduced. For instance, the car and motorcycle industries, which enjoy the highest rates of tariff protection among all manufactured goods, will be threatened (but only if the quality of Chinese motor vehicles and motorcycles improves). Yet, the overall impact on manufacturing employment in the Philippines may not be as large as the positive impact in sectors that may expand due to greater access to the Chinese market (such as bananas, pineapples, and mangoes). Finally, given the relatively short distance between the two countries and the large and growing Chinese middle class, the prospects are great for the tourism sector in the Philippines.

Bright as the prospects are, however, there would be substantial psychological barriers to the idea of a free trade agreement that includes China and the Philippines. China's offer of early harvest is a good start, but has probably not tipped public opinion in favor of a free trade agreement with China. Maybe China should change tactics and unilaterally open its markets to the Philippines. Such a move will most likely result in a significant increase in Philippine exports to China, which the latter can ultimately use as a bargaining chip to draw the Philippines into a free trade agreement (for example, by threatening to raise the barriers again).

On ODA and East Asian economic integration

There has been quite a bit of talk (such as at the last ADB meeting in Hyderabad) about the need to expand ODA to help lagging economies prepare for economic integration in the region. In particular, infrastructure and human resources are often cited by investors as important factors in the decision on where to locate. On the other hand, despite the fact that economic integration has resulted in a high concentration of economic activities in or around metropolitan areas, there is little resistance to economic integration within countries. This is so because significant fiscal transfers (in both cash and kind) related to integration tend to reduce human resource and infrastructure gaps among regions within countries. Still, many developed countries are nowhere near their commitment to allocate at least 1 percent of GNP to ODA.

However, it is unrealistic to expect ODA to make a major dent in resolving the problem of the lack of international competitiveness in lagging countries such as the Philippines. For example, the government of the Philippines spends much less on infrastructure than do other Asian governments (see table 12.8), and the gap is so wide that infrastructure problems in the Philippines will be properly addressed only if the Philippines undertakes significant fiscal and policy reforms (World Bank 2005).

Nonetheless, ODA can play a strategic role in infrastructure development in the Philippines. Political forces and processes in the Philippines have a tendency to spend too little on infrastructure and spread the already small total investment thinly among the various political districts of the country. In contrast, Philippine exports would probably be more competitive if the Philippines were to give priority to infrastructure investments within a relatively narrow corridor connecting the former U.S. military bases north of Metro-Manila and the Batangas port south of the metropolis.

The reason ODA-funded infrastructure does not have to be spread as thinly as locally funded infrastructure projects is that ODA institutions (such as the ADB, the Japan Bank for International Cooperation, and the World Bank) have quite a bit of leverage if they want to focus infrastructure assistance in a few areas. In short, an alliance between national government agencies and ODA institutions can improve the efficiency of infrastructure investments (to the extent that concentrating infrastructure spending in a few strategic areas is efficient, but not now politically feasible). This presents a dilemma for multilateral and bilateral sources of ODA funds because the emphasis on the Millennium Development Goals tends to result in assigning a higher priority to less developed areas, However, the dilemma can be resolved by deciding that a certain proportion of the ODA should go to the goals and a certain portion should go toward enhancing international competitiveness (the criteria for which may vary from country to country).

TABLE 12.8. Government Capital Expenditures as a Share of GDP
percent

Year	*Indonesia*	*Malaysia*	*Philippines*	*China*	*Korea, Rep. of*	*Thailand*
2004	14.1	6.1	—	—	3.5	—
2003	13.2	9.7	1.6	4.0	4.2	2.8
2002	9.9	9.7	1.7	4.4	4.3	3.7
2001	9.1	10.2	1.6	4.2	4.0	3.7
2000	3.1	7.3	1.8	4.0	3.8	3.9
1999	—	7.1	2.1	3.9	4.6	4.9
1998	—	6.0	1.6	3.2	4.2	6.0

Source: Compiled by the author based on data from the ADB Asia Regional Information Center (http://aric.adb.org).
Note: — = no data available.

Conclusion and future prospects

The gains from trade will be both large and unequally distributed if the evolution of trade and foreign investments is driven by learning by doing, endogenous technological change, and scale and agglomeration economies. Thus, advanced countries such as Japan and rapidly growing economies such as China have good motives for taking the lead toward greater economic integration in East Asia. However, economies such as the Philippines that have not performed well for various reasons are also the least likely to be favored by trade and investment flows driven by the forces listed above. Economic integration will result initially in unequal gains from trade. Only much later, after the congestion costs and labor costs have risen in the successful countries, will lagging countries such as the Philippines get a bigger share of the gains from trade.

Yet, the lagging countries cannot opt out. Protectionist development strategies require much better governments than those the lagging countries have (and may, in fact, be the reason they are lagging in the first place). The greater the number of countries joining an FTA, the costlier not being part of the FTA becomes. Moreover, the lagging countries may benefit, too, by exporting labor and by finding niches not requiring agglomeration economies that are as extensive as those in rapidly growing economies.

That trade and investment flows do not benefit all countries equally should not be surprising. Trade and the movement of factors of production within countries have the same effect, creating huge cities even in the least dynamic economies. The difference, of course, is that the fiscal systems of nation states may redistribute gains from the intracountry movement of goods and factors. In the case of the benefits of economic integration, however, little transfer will take place between countries that gain a lot and countries that gain little, and there is not much to be obtained by stepping back from the “trade not aid” to the “aid not trade” debate. The aid will never be sufficient to matter significantly because the countries that benefit most from trade also must address their own strong domestic constituents.

Movements of people may possess the potential to mitigate the problems of the unequal gains from trade. But migrant workers from lagging countries can only hope that successful countries will open their doors and treat them well.

Nevertheless, there is reason to be more optimistic about the prospective benefits going to the Philippines from greater East Asian economic integration, especially with regard to the country's experience with trade liberalization in the 1980s and 1990s. The Philippines did gain from the freer trade in the 1980s and 1990s, but the gains were partially masked by the decline of uncompetitive industries that were exposed to foreign competition by trade liberalization. There were gains from freer trade. It just so happened that there could be no gain without pain since both the production and employment levels of uncompetitive industries would inevitably have to be shrunk as tariffs and nontrade barriers were reduced or eliminated. In a way, the withering away of uncompetitive industries (many of which needed more than twice each dollar equivalent of domestic resources to save a dollar at the prevailing exchange rate) was only a matter of time. And, in a sense, it is better the Philippines made the adjustment at least a decade ago rather than now, when the internal dynamic forces that drive growth in the region are much stronger and the region has become more integrated. In other words, except for agriculture, the social cost to the Philippines of greater East Asian economic integration is going to be much less than the cost the country incurred as a result of trade liberalization in the 1980s and 1990s. Thus, the Philippines has already paid many of its dues, and the remaining dues to be paid are relatively small, especially in comparison with the gains to be derived from becoming integrated with dynamic economies that are much closer to the Philippines than the country's Western trading partners.

Finally, perhaps the best argument for economic integration is that integration will make the fact some countries are ahead and some are behind more obvious. And the peoples of the lagging countries will then start asking their governments the reason why this is so.

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