

Trade and Investment in the Philippines

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This work provides a sample of studies on trade and investment in the Philippines. The first section reviews the literature on Philippine trade, particularly the evolution of the country's trade policy and its ensuing impact on different sectors and aspects of the economy. The second section looks at the literature on foreign direct investments (FDIs) in the Philippines. In particular, the section reviews research done on FDI policies, determinants of FDI, and the impact of FDIs on the economy. The third section looks at studies that tackle economic integration—a consequence of both trade and investment liberalization. The last section concludes and recommends possible areas of future research.¹

Evolution of Philippine Trade Policy

The literature covering the developments in the Philippines' trade policies is rich. Wignaraja, Lazaro, and De Guzman (2010); Balboa and Medalla (2006); Balisacan and Hill (2003); Austria (2001); Cororaton (1998); and Austria and Medalla (1996) are among the many studies that provide a comprehensive account of the Philippines' trade regime in different decades.

Philippine trade policy has experienced major shifts over the past 60 years. From the 1950s–1970s, the government embarked on an import-

substituting trade regime. These decades can be characterized by highly protective tariffs, foreign exchange control measures, and capital market interventions. Realizing the limitations of such strategies, the government modified the country's trade policy using various liberalization packages. Thus, the first half of the 1980s saw the introduction of a tariff reform program (TRP), which involved the "tariffication" of quantitative restrictions, simplification of the tariff rate structure to a narrower rate range, and reduction in tariff protection. This was followed by two more waves of tariff reform programs in the 1990s—TRP II and TRP III. TRP II was introduced in 1991 and is an extension of the program introduced in the 1980s. Under TRP II, a phase-in period and transition rates were included in the tariff structure (Cororaton, 1998). TRP III, meanwhile, was introduced in 1994, in response to the request of the private sector to lower tariffs on capital goods and raw materials to improve their competitiveness (Menardo, 2004). The Philippines' accession to the World Trade Organization (WTO) in 1995 also called for another set of liberalization packages to comply with WTO commitments. Among these include the lifting of import restrictions on certain agricultural products, the elimination of duties on certain industrial and information technology products, and the creation of a four-tier tariff schedule. Further trade policy liberalization was introduced in the 2000s to support the government's commitment to market-friendly regulations (Menardo, 2004). For instance, by 2010, duties were eliminated on 99% of products in the Inclusion List of the Common Effective Preferential Tariff (CEPT) scheme of the ASEAN Free Trade Area (AFTA) (Palabyab, 2010). In 2008, the Japan—Philippines Economic Partnership Agreement (JPEPA) was enforced, which is the Philippines' first bilateral free trade agreement.

Impact of Trade Liberalization

The push for trade liberalization in the Philippines was primarily due to the failed protectionism and import substitution strategy implemented in the decade of the 50s and 70s. Trade liberalization is expected to improve the allocation of resources and bring domestic prices closer to world price, which are, in turn, expected to deliver sustained economic growth and development. However, with the mixed experience of different countries that have undergone trade liberalization, a recurring question is whether trade liberalization enhances productivity and economic growth, helps reduce income inequality, and alleviates poverty in a developing country.

Productivity

The focus of many studies on the impact of trade liberalization on productivity stems from the prediction that liberalization of trade influences producer behavior (Urata, 1994). Foreign competition brought by trade liberalization forces domestic firms to improve their productivity in order to survive. In addition, trade liberalization allows domestic firms to use high-quality imported components and machinery at lower prices, thus improving their productivity.

In a cross-country study covering the Philippines, Korea, Taiwan, Thailand, Malaysia, Indonesia, and India for the period 1970 to 1991, Urata (1994) investigated the impact of trade liberalization on each country's total factor productivity (TFP). Using tariff rates and the volume of exports and imports to capture trade liberalization, results revealed that for most countries in the sample, including the Philippines, trade liberalization had a positive impact on TFP growth; however, the relationship is not always statistically significant or stable. Austria (2000) and Cororaton and Abdula (1999) used the same measures to capture the impact of trade on the TFP of the Philippines. The former covered the years 1960 to 1996, while the latter covered 1958 to 1991. Austria (2000), using cointegration techniques, found that exports had a positive and significant impact on TFP, while Cororaton and Abdula (1999), using multivariate regressions, found that exports only had marginal impact on TFP. Both studies showed a negative coefficient for imports. Austria (2000) explained that the country's lack of skilled manpower to operate imported machines and transport equipment has led to a fall in productivity. Meanwhile, Cororaton and Abdula (1999) asserted that this is accounted for by the type of technology adopted by industries and its integration with the economy's forward and backward linkages. While Cororaton and Abdula (1999) found that low period differences in tariff rates have negative and significant impact on TFP,² Austria (2000) found that tariff rates have an insignificant impact on the country's TFP.

Aforementioned studies generally found that trade liberalization in the Philippines has limited impact on productivity. Moreover, foregoing researches have used macro-economic data since the Philippines does not have a readily available micro-level database to study the effect of trade liberalization on productivity. Surveys have to be carried out in order to conduct studies that are based on micro data. Hallward-Driemeier, Iarossi, and Sokoloff (2002) used plant-level data for four East Asian economies—the Philippines, Indonesia, South Korea, and Thailand—to analyze how the extent of trade openness in markets influence manufacturing productivity. In particular, they investigated whether exporters or firms that are more

integrated to broader markets have higher productivity than nonexporters. The analysis for the Philippines was based on a survey conducted in the late 1990s covering 424 registered firms with at least 20 employees in the food, textile, garment, chemical, and electronic sectors. Using multivariate regressions, the study revealed that exporters are more productive than nonexporters. In addition, the productivity gaps were found to be larger in the Philippines and Indonesia, which were identified as having less developed domestic markets compared to South Korea and Thailand. The study also showed that greater access to world markets drives firms to carry out investments that improve their productivity.

Aldaba (2010) assembled a firm-level panel data set of Philippine manufacturing establishments covering an eight-year period from 1996 to 2006 (1999, 2001, and 2004 are missing).³ The study focused on the impact of major trade reforms on the productivity of different types of firms in different sectors, where the classification was based on the sectors' trade orientation—traded sector (purely exportable, purely importable, and mixed) and nontraded sector. Greater exposure to international trade due to trade liberalization can drive efficient domestic firms to expand and the less efficient ones to shrink or exit the market. Hence, trade liberalization restructures and reshuffles the resources and activities within and across sectors. Employing a nonparametric approach, results of the study provided evidence that trade liberalization leads to increases in productivity, while protection reduces productivity. Moreover, aggregate productivity growth in the purely importable sector and mixed sector declined, while aggregate productivity in the purely exportable and nontraded sectors both improved within the period of the study.

In contrast to other developing countries that have a readily available national database of firms (for instance, Indonesia, Mexico, and Venezuela), the Philippines does not have such data available. Thus, the work of Aldaba (2010) offered a novel way of analyzing the impact of trade liberalization on the productivity of Philippine firms. Although insights provided by studies using macro data are valuable, important relationships may be concealed. Efforts in organizing a micro-level database in the Philippines such as the one assembled by Aldaba (2010) should be further encouraged, as using micro-level data may provide a more fruitful analysis.

Economic Growth

Several studies analyzed the impact of trade on economic growth. The promotion of production efficiency, better allocation of resources, and increase in the competitiveness of domestic products brought by trade

liberalization are among the reasons why the latter is predicted to have a positive impact on economic growth.

Using the APEX Model,⁴ Cororaton (1996) conducted simulations to investigate how sectoral nominal and implicit tariff rate changes during the 1988–1992 period affect economic growth. Results show that changes in nominal tariff rate lead to annual real GDP increases by 0.47% on average. With the aid of a financial computable general equilibrium (FCGE) model of the Philippine economy, Cororaton (1997) determined that a tariff reduction program—utilized during a flexible exchange rate regime—has a direct and wield the largest impact on output.

Meanwhile, using the PIDS macroeconomic model, Yap (1997a) simulated the changes in tariff from 1993 to 1996 to investigate the impact on aggregate and sectoral economic output. Results showed that aggregate economic output increased due to the decline in the average tariff rate. In addition, all major sectors showed output improvement. Nevertheless, effects differ across major sectors—the industry sector benefited the most, whereas the agricultural sector gained the least during the period. Using a smaller macroeconometric model, Yap (1997b) conducted simulations to investigate the impact on the economy of an across-the-board uniform tariff of 5%. Results revealed that that the policy leads to greater demand for imports, which leads to deteriorating trade deficits. In addition, the rise in import volume does not make up for the reduction in the tariff rate, resulting to the weakening fiscal balance. Results implied that reduction in tariff makes macroeconomic constraints more restrictive, which leads to a definite reduction in investment and, subsequently, in a slower rate of growth. In contrast, Tan (1997), employing a partial equilibrium trade model based on input-output framework, discovered that a 5% uniform tariff has positive effects. Output can increase as a result of improvement in resource allocation in the tradable sector. In addition, output and income growth can be higher at a lower uniform tariff. On a sectoral basis, the manufacturing sector had the highest growth rate, while agriculture had the least fall in output. Focusing on the trade reforms for the period 1995–2000, Cororaton and Cuenca (2000) used a 50-sector CGE model of the Philippine economy and found that over the period, real GDP improves. Nevertheless, variations in sectoral and annual effects exist, depending on the trade reform considered.

Income Distribution and Poverty

Traditional trade theory predicts that trade liberalization would have income distribution effects. In particular, the Heckscher–Ohlin (HO) model predicts that trade liberalization will cause a decline in income inequality

in developing countries—economies that, in general, have ample supply of unskilled and less skilled workers. Nevertheless, the empirical literature shows mixed evidence of this prediction.

Yap (1997a) showed the impact of tariff changes from 1993 to 1996 on income distribution by incorporating an income distribution model in a macroeconometric model. Results revealed that income distribution deteriorated, possibly due to the difference in the impact of the tariff change across sectors. While all sectors registered a positive increase in output, the industrial sector posted the biggest positive increase and the agricultural sector registered the least. Since the majority of lower income households in the Philippines still depend on the agricultural sector, the relatively lower output growth in agriculture creates adverse income distribution effects.

Meanwhile, using the APEX model mentioned earlier, Cororaton (1996) investigated the effects of the tariff changes from 1988 and 1992 on income distribution. The results revealed improvements in income distribution during the period, where households in the poorest income bracket experienced the greatest increase in income compared to the richest income bracket. Furthermore, among the prices of unskilled labor, skilled labor, and capital, the price of unskilled labor obtained the highest increase for both fixed and flexible exchange rate regimes. Since unskilled labor mostly belongs to the poorest segment of the population, this benefits the poor. Moreover, the price of capital increased faster relative to the general price of labor. This led to some kind of a substitution effect in favor of labor, thereby implying favorable income distribution effects.

Similarly, Cororaton (1998) and Cororaton and Cuenca (2000) found that the effect of tariff reforms on income distribution was generally positive. Cororaton (1998) used a 34-sector economy-wide model and found that for the period 1990 to 2000, the impact of the tariff reforms on income distribution is generally favorable, especially in the second half of the 1990s. In particular, all income groups enjoyed an increase in their absolute income due to the tariff change. Nevertheless, the impact differs across income groups, with the lowest increase in the poorest household. In addition, resource allocation across sectors changed as a consequence of the tariff change; where a general resource shift from agriculture and construction to manufacturing and utilities was observed. Meanwhile, Cororaton and Cuenca (2000) found that for the period 1995 to 2000, the lowest income group registered the highest increase in income relative to the other income groups.

Hasan and Jandoc (2010) showed that trade reforms did not significantly affect income inequality. Using wage decomposition techniques and multiple regression methods, the study examined the impact of trade liberalization on wage inequality in the Philippines for the period 1994 to 2000, wherein trade

protection declined and inequality rose significantly. The study suggested that trade liberalization did not significantly contribute to inequality in the country. In particular, results of the study revealed that trade-induced impacts on industry wage and industry-specific skill premia do not worsen wage inequality. Changes in economy-wide returns to education and changes in industry membership appeared to be more important drivers of wage inequality. In addition, the impact of trade liberalization on wage inequality was mainly attributed to trade-induced employment reallocation effects, wherein the decline in trade protection caused a movement of employment to more protected sectors, in particular to services, where wage inequality tended to be high from the beginning.

Cororaton, Cockburn, and Corong (2005) focused on the possible impact of free trade and the Doha agreements, in particular, on Philippine poverty by employing a detailed CGE analysis. Various policy experiments reveal mixed effects. The implementation of Doha agreements was found to marginally increase poverty. In particular, rural households and the agricultural self-unemployed, where the poorest and most populous households in the country belong, are adversely affected due to reduced world prices and lower demand for the Philippines' agricultural exports. Meanwhile, full trade liberalization, that is, free world trade, marginally reduces the poverty incidence. Free world trade increases industrial exports, which favors urban households. The agricultural sector likewise benefits as the cost of competing agricultural imports increase.

Labor Market

One sector of the economy frequently examined in analyzing the impact of trade liberalization in a country is the labor market. Specific attention is often given to employment and wage effects as these have important welfare implications.

Cororaton and Cuenca (2000) found that tariff reductions from 1995 to 2000 led to generally favorable employment effects, albeit with apparent gainers and losers across sectors. In particular, a significant increase in industry employment is registered. However, declines were registered in agriculture and services. Meanwhile, Orbeta (2002) analyzed the impact of globalization, measured by trade flows, on employment level and structure for the years 1980 to 2000, at both the aggregate and manufacturing sub-industry levels. At the aggregate level, results of the study showed that labor demand increases with higher propensity to export and import. At the manufacturing sub-industry level, greater export propensity has a positive impact on labor demand, while import propensity has an insignificant

impact on labor demand. In terms of employment structure, at the aggregate level, trade openness does not show a significant impact on the proportion of women workers employed, but at the manufacturing sub-industry level, the increase in the propensity to export is beneficial for women workers. In addition, increases in export propensity raise the proportion of low-skilled production workers employed at the national and manufacturing sub-industry levels. Orbeta (2002) concluded that expansion in exports has increased the demand for workers in the Philippines with basic skills.

Hasan and Chen (2003) examined the impact of trade liberalization on wages and employment in the Philippines' manufacturing sector in the period 1988 to 1997. The results of the study revealed that trade liberalization had fairly modest effects on both relative industry wages as well as employment in the Philippines within the period of the study. However, not all groups of workers were left unaffected by liberalization. Workers in capital-intensive industries, especially skilled ones, experienced declines in industry wage premiums. Less skilled workers in capital-intensive industries, meanwhile, appeared to have to work longer hours as a result of trade liberalization.

While most studies on the impact of trade liberalization on the Philippine economy focused on trade in goods, very few researches have been done so far on the impact of liberalization in trade in services on the economy. An exception is the study of Amoranto, Brooks, and Chun (2010).

Amoranto et al. (2010) investigated the impact of services liberalization in banking, telecommunications, and distribution on employment and wages in the Philippines for the years 1991 and 2004. In particular, the study estimated the probability of full-time stable employment and the effect on wages given services liberalization in aforementioned services. The results of the study revealed that, in general, liberalization in the services considered in the study had no noteworthy influence on employment in stable jobs for males and females. However, it is associated with wage reductions for females and higher wages for males in full-time salaried work. Among the three industries, liberalization in telecommunications had the biggest effect in terms of cutting employment in stable jobs and in trimming down the wages of full-time salaried workers for both males and females. Meanwhile, compared to telecommunications and banking, liberalization in distribution services favored workers with bigger wages across different levels of education (except for workers in the lowest category of educational attainment who either have no education or only elementary education). Moreover, results suggest that services liberalization appear to have possibly harmed those with little education and may have shifted employment to higher skilled males compared to females.

Environmental and Labor Practices

An important strand in the international trade literature is the link between trade liberalization and the environmental and labor practices in a country. Traditional literature suggests that there is a race to the bottom among countries participating in international trade. Lower labor and environmental standards lead to lower production costs, which enable exporting firms to be more competitive internationally. Nevertheless, increased awareness of environmental and labor issues and the presence of foreign competitors that produce at higher standards may pressure domestic producers to adopt higher standards. Moreover, some developed countries require that certain standards be met and tests be passed by goods exported in their countries, for instance, ISO certification, sanitary and phytosanitary (SPS) standards, and eco-labels. However, studies on this topic for the Philippines are scant.

Aldaba and Cororaton (2001) assessed the effect of trade reforms on the environment and environmental standards using CGE model simulations and industry case studies. The results of the study revealed that trade liberalization does not lead to general environmental degradation but promotes competition and efficiency. Large export-oriented firms appear to be the advocates of sound environmental practices and are the first to implement environmental management system. The critical role played by technology in controlling pollution is likewise recognized. In particular, simultaneously introducing changes in technology and trade reforms lead to significant improvements in the environment.

Meanwhile, Edralin (2000) investigated the position of enterprises regarding social clauses. A social clause espouses the integration of international labor standards (set by the International Labor Organization) in international trade agreements to guarantee that trade liberalization will be accompanied by improvements in conditions at work and not by race to the bottom that exploits labor. On the one hand, better labor conditions are expected to increase the productivity of workers, enabling them to be more competitive. However, higher labor standards may come at a cost to firms, reducing or eliminating their edge against the lower labor cost in other developing countries. Based on a survey of 125 enterprises in the manufacturing sector, the study revealed that many of those belonging to management and union are in favor of a social clause. Enterprises that are in favor of a social clause 1) belong to the chemical products subsector, 2) are owned by Filipinos, 3) are registered as single proprietorships, 4) have a large employment size, 5) have medium capitalization, 6) had an average profit the previous year, and 7) have been operating its business for 2–10 years. Meanwhile, enterprises that are not in favor of a social clause are mainly those that are in the textile and wearing apparel and furniture and

wood product industries. Small businesses, in particular, are concerned of the lower labor costs in countries such as China and Vietnam. Nevertheless, Edralin (2000) highlighted the need for labor standard reforms to ensure long-term competitiveness and that the Philippines gives globalization a human face.

Foreign Direct Investments

Most developing countries are capital scarce and have limited access to international financial markets relative to developed nations. Since capital accumulation is recognized to foster economic growth, many developing nations offer incentives to attract FDIs as an alternative source of capital. Apart from the inflow of capital, FDIs are expected to introduce a myriad of favorable productivity spillovers in the host country—technological advancement, improved research and development, superior management skills, and expanded marketing network, among others. Hence, FDIs are expected to promote growth and enhance welfare. Due to these expected benefits, there is vigorous effort by developing countries, the Philippines included, to attract FDIs.

Evolution of Philippine Foreign Direct Investments Policy

Many studies have examined the FDI experience and investment policies of the Philippines. Aldaba (1994), for instance, provided a very comprehensive discussion of the Philippines' FDI policies and patterns from the 1960s to the 1990s. Aldaba (2006) and Balboa and Medalla (2006), on the other hand, provided a summary of FDI patterns and policies in the 1980s to early 2000s. Additionally, Matriano (2002) provided a brief summary of the Philippine FDI experience for the period 1997 to 2001.

Similar to trade policy, investment policy in the Philippines has undergone reforms. Beginning in the 1980s, the standpoint of the Philippines toward foreign direct investments has changed considerably (Aldaba, 2006). One of the most important steps undertaken to liberalize investment policy in the 1980s was the passage of the Omnibus Investments Code (OIC, 1987). The OIC of 1987 simplified and consolidated previous laws and provided two important incentives, namely, the provision of income tax holiday for enterprises engaged in preferred areas of investment and taxable income deductions for the use of skilled and unskilled workers that satisfy certain requirements of the Board of Investments (BOI). Other incentives in the OIC include tax and duty exceptions on certain capital equipment and parts,

tax credits on domestic capital equipment, employment of foreigners for technical and advisory positions for a certain period, and simplified customs procedures.

In the 1990s, an important step taken to liberalize investment policy was the Foreign Investment Act (1991), which liberalized existing investment regulations. In particular, foreign equity participation up to 100% was allowed in all areas unless the investment is prohibited or limited under the Foreign Investment Negative List. Over time, the negative list was considerably reduced.

In 1994, entry and operations of foreign banks were liberalized. Foreign banks were allowed to acquire up to 60% ownership of domestic banks. The capital market was likewise liberalized with the removal of some foreign exchange controls, including the surrender requirement for export proceeds and Bangko Sentral ng Pilipinas (BSP) approval of forex transactions and capital repatriation.

In 1995, the Special Economic Zone Act (1995) allowed increased private-sector participation in the development and management of the country's special economic zones and expanded the activities permitted within the zones. According to the World Bank (1997), the integrated package of policies, rationalized procedures, and physical infrastructure offered by economic zones resulted in a net positive economic impact.

By the 2000s, more liberalization efforts specific to FDI were undertaken. For instance, in 2000, the General Banking Law (2000), for a period of seven years, allowed foreign banks to own up to 100% of one locally incorporated commercial or thrift bank (with no obligation to divest later). The Retail Trade Liberalization Act (2000)—that was likewise passed in 2000 permitted foreign investors to enter the retail business and have 100% ownership (with minimum equity requirement).

Though considerable advancements have been made in liberalizing the country's FDI policy, obstacles to foreign investment entry still remain. For instance, due to constitutional constraints, foreign investment is restricted in certain industries—mass media, small-scale mining, private security agencies, and the manufacture of firecrackers and pyrotechnic devices, among others. Limit on foreign ownership remains on enterprises engaged in domestic air transport, public utilities, pawnshop operations, education, and employee recruitment, among others.

Determinants of Foreign Direct Investments

Despite the steps taken to liberalize investments in the country, studies show that FDI inflows in the country have displayed unstable patterns of

growth and the Philippines has lagged behind its neighboring countries in attracting FDI inflows. The FDI experience of the Philippines brings to attention whether or not the country has the necessary conditions and environment conducive for attracting and maintaining investments. This is a very important question and, thus, has been the subject of much research.

Austria (1998) identified the factors that explained FDI patterns in the Philippines in the 1990s. Factors that attracted FDI in the 1990s include the government's general policy of openness, strong macroeconomic fundamentals, economic recovery, and political stability. Meanwhile, factors that inhibited FDI include the militancy of labor unions; inadequate technical and vocational skills of the labor force; high cost of unskilled labor relative to Indonesia, Vietnam, or China; slow growth of labor productivity relative to wage increases (primarily due to minimum wage setting); poor infrastructure; and lack of competitive support industries.

Aldaba (1994) empirically explored the factors influencing FDI inflows for the period 1973 to 1992. The results of the regression analysis showed that FDI inflows is positively correlated with the stock of public investment, real GDP, and the real effective exchange rate and is negatively related with political instability. Changes in investment incentives were also shown to have no influence on FDI inflows in the period of the study. In addition, for the period considered, FDI inflows were shown to be positively related to the effective rate of protection and that most FDI inflows were import substituting. Aside from analyzing the behavior of aggregate FDI inflows, Aldaba (1994) disaggregated the FDI inflows coming from the US, Japan, and the EC6. The results show that FDI inflows from these sources respond distinctly to different factors considered in the study.

The results of Alburo (1998) showed some similarities to that of Aldaba (1994), albeit working on a different time period. Based on the analysis of FDI inflows for the period 1985–1997, the real exchange rate, effective protection rate, and rates of return were shown to have positive impacts on FDI inflows, while the amount of commercial credits has a negative impact on FDI inflows. Bilateral investment treaties of the Philippines, meanwhile, were shown not to have significant impacts on the country's FDI inflows.

Notable is the positive and highly significant impact of the effective protection rate in both studies, suggesting that the FDI attracted by the Philippines are in general not export oriented. Alburo (1998) mentioned that this is not to undermine the growing importance of FDI in export-oriented subsectors (i.e., electronics) but merely shows that FDI inflows in the period covered by the studies were in general, not attracted to the exporting sectors of the country.

Balboa and Medalla (2006) provided a descriptive analysis to explain the FDI experience of the Philippines. Based on the work of Banga (2003), they identified three categories of government policies, namely, overall economic policy, national FDI policies, and international FDI policies that affect FDI inflows in a country. The first category includes investments in infrastructure, in particular, environmental and urban management (waste and traffic management), where the Philippines is lagging, and industrial power supply, where the Philippines has a high cost compared to other Asian countries. Wage and labor productivity relation likewise fall under this category, where it was identified that the Philippines has one of the highest minimum wages in Asia and yet has one of the lowest labor productivity. The second category includes the tax structure and tax administration in a country. While Aldaba (2006) maintained that the Tax Reform Package in 1986, the Comprehensive Tax Reform Program in 1994, and the Tax Reform Act of 1997 have significant positive impacts on the Philippine tax system, Balboa and Medalla (2006) maintained that the Philippines still has one of the highest corporate and value-added taxes compared to its neighbors. Likewise, the Philippines' lack of tax administration transparency and reputation for tax evasion have had negative impacts on the investment climate of the country. Another important policy under this category is fiscal incentives, where the Philippines was identified to have a fairly competitive incentive package vis-à-vis other ASEAN countries. Restrictions and limitations in foreign investments and land ownership also fall in this category. While the Philippines has undergone extensive liberalization with regard to investment and land ownership (Matriano, 2002), Balboa and Medalla (2006) declared that the country still has one of the most restrictive rules compared to its ASEAN neighbors. Related to this, the authors claimed that countries with stricter rules on investment and land ownership often resulted in more corruption. The third category includes the membership of a country in bilateral investment treaties (BIT) and economic partnerships. As of June 2012, the Philippines has signed 35 BITs, 30 of which have already been entered into force (United Nations Conference on Trade and Development, 2012).

While the analysis of Balboa and Medalla (2006) is useful in identifying the policies that could be improved on to promote greater FDI inflows, the study did not identify which among the policies require the most attention and have the most impact in terms of influencing FDI inflows. With the government's lack of resources, it is imperative to ascertain which among these factors to prioritize. The Asian Development Bank (ADB, 2005) conducted a survey in 2003 in four manufacturing sectors, namely, food and food processing, garments, textiles, and electronics, that

somewhat addresses this concern. It analyzed the relative importance of macroeconomic fundamentals, infrastructure, governance, and institutions to investors. The result of the survey revealed that macroeconomic stability, corruption, electricity, tax rates, and economic policy uncertainty are the top five concerns of investors in the country. A periodic study similar to the foregoing should be encouraged and should be extended to other sectors (i.e., service, which is growing in economic importance). Such surveys and studies can serve as a monitoring mechanism for whether or not the concerns of investors are adequately addressed by the government.

Instead of simply enumerating and describing the policies and factors that require government attention, another approach that could be taken is to choose an existing FDI policy and analyze its economic importance vis-à-vis the cost of implementing it. An example of such a study is Reside (2006, 2007), which focused on fiscal incentives. The results of both studies showed that fiscal incentives are not significant and that fundamental factors are more important in attracting FDI and regional investments in the Philippines. Reside (2006, 2007) suggested that government resources should instead be spent on productivity-enhancing goods such as education and infrastructure.

Impact of Foreign Direct Investments

While it is important to review the country's history of FDI policies and determinants of FDI inflows, it is equally important, if not more important, to investigate the impact of FDI in the country.

In a cross-country study of nine Asian countries including the Philippines, Dhakal, Rahman, and Upadhyaya (2007) investigated whether or not there is a two-way causality between FDI and economic growth over the period 1980 to 2001. It showed varying results for different countries. In the case of the Philippines, it was revealed that while FDI causes economic growth, the latter also stimulates the former. Thus, there is a two-way causality between the two. The causality from FDI to growth is reinforced by the presence of greater trade openness, more limited rule of law, and lower receipts of aid. The causality from growth to FDI, meanwhile, is strengthened by greater political rights and more limited rule of law.

Instead of looking at the amount of FDI inflows, Choong and Liew (2009) investigated the impact of FDI volatility on economic growth for the ASEAN-5 for the period 1974 to 2005. The study showed cointegration between FDI volatility and economic growth, implying a long-run relationship between the two. In particular, FDI volatility has a significant and negative impact on the economic growth of the ASEAN-5, albeit not

significant for Singapore. In the case of the Philippines, a 1% increase in FDI volatility is associated with a 0.41% rise in economic growth. Among the countries considered in the study, the Philippines' economic growth is the least vulnerable to FDI volatility. At first look, this may be encouraging since this implies that the country's economic growth is not highly dependent on FDI inflows. However, one possibility for this result is that the FDI inflows in the Philippines may be small relative to that of other countries in the study, thus the small observed impact on the country's economic growth.

The study of Bende-Nabende and Slater (2003) investigated the impact of FDI on domestic private investment in both the short run and long run covering the period 1971 to 1999 for four ASEAN countries: Indonesia, Malaysia, Thailand, and the Philippines. The results showed that in the short run, FDI significantly crowds in domestic private investment in the Philippines and Thailand, while in Indonesia and Malaysia, there is insignificant crowding in and insignificant crowding out effects, respectively. The authors noted that in the short run, FDI tends to crowd in domestic investment in relatively less developed countries but crowd out in domestic investment more developed ones. In the long run—it was shown that there is significant crowding in of domestic investments for the four countries.⁵

The preceding discussion shows that the empirical literature on the impact of FDI on the Philippine economy is scant. In addition, aforementioned studies are cross-country wherein the Philippines is just one of the observations; thus, they fail to provide a detailed analysis for the Philippines. One recent study by Agbola (2007) is an exception. The study empirically investigated the impact of FDI on the Philippines' economic growth in the period 1970 to 2006. The results found that FDI can positively influence economic growth by stimulating human capital and infrastructure development. The study also suggested that FDI might be more important than domestic private investment in enhancing economic growth. The precise mechanism of how FDI affects economic growth and domestic investment depends on a myriad of factors, but aforementioned studies are unable to provide a detailed explanation as they use highly aggregated data. Hence, conclusions are at best suggestive. However, FDI is shown to crowd out domestic investment, which is in contrast to the findings of Bende-Nabende and Slater (2003). In such case, caution must be made when making policy recommendations. For instance, if evidence of crowding out of private investment is found at the aggregate level, it does not necessarily imply that there is no crowding in at the sectoral, industry, and firm level. Moreover, it cannot be concluded that all types of FDI crowd out domestic investment. Likewise, the specific conditions why crowding out is found may be hard to identify.

Economic Integration

Liberalization in trade and investment throughout the years have contributed to greater economic integration. Reforms done in the 1980s and 1990s have reduced the inefficiency of domestic industries that were products of past protectionist policies. As a result of the liberalization efforts, the country's competitiveness improved, which enabled it to participate in international trade agreements.

Austria (2004) mentioned market-led process, institution-led process, and private-sector-led process as the main drivers of economic integration. Market-led process results in greater trade and investment opportunities through international production sharing. Institution-led process is spurred by free trade agreements. And private-sector-led process is driven by economic zones across geographically contiguous countries in a region.

International Production Sharing

International production sharing exploits the comparative advantage of different countries in producing different parts and components of a good. The Philippines participates in this production scheme primarily through the labor-intensive production processes. The studies of Austria (2003a, 2003b, 2003c, 2004) revealed increasing economic integration of the Philippines as suggested by its growing intraindustry trade with trading partners. In particular, Austria (2003a) showed a growing intraindustry trade in manufactures between the Philippines and APEC members, especially in semiconductors and electrical machineries. Likewise, from 1990 to 1999, Austria (2003c) pointed to a rising intraindustry trade in manufactures between pairs of ASEAN economies. Similarly, intraindustry trade in ASEAN priority goods sectors between the Philippines and ASEAN countries from 1997 to 2001 increased, though large variations across sectors and partner countries are apparent, as revealed by Austria (2004). Nevertheless, integration is still considered weak, which can be primarily attributed to the variation in the speed of integration of member countries and stark differences in the level of development of member countries. Austria (2004) likewise mentioned the rapid emergence of China as an economic power as an important challenge for the Philippines and the ASEAN in general.

By focusing on the electronics industry, Austria (2006) asserted that the country has hardly progressed in its participation in the global production chain, as the country remains in the level of assembly and testing segments that generate the lowest value added. The primary reason for the failure of the

economy to move to higher value-added segments of the production chain is the lack of local support structures in the country, in particular, in the areas of infrastructures and logistics, power supply and costs, unskilled labor costs, development of supplier industries, and technological capabilities that constrain industrial upgrading.

Trade Agreements

The unilateral and multilateral lowering of impediments to trade and investment has led to greater economic integration across economies. The Philippine government's participation in various agreements is a signal of its commitment to liberalize trade and investment. Numerous studies have been conducted to estimate the impact of trade agreements on the Philippine economy.

The ASEAN Free Trade Area (AFTA) was established in 1992 and is the Philippines' first free-trade agreement. Its principal goal was to increase ASEAN competitiveness as a production base for the world by reducing intraregional tariffs to 0% to 5% within a 15-year period through the Common Effective Preferential Tariff (CEPT). Pineda (1997) identified the net exporting industries to ASEAN as the major gainers of CEPT in the Philippines. Meanwhile, using a CGE model and the Global Trade Analysis Project (GTAP) model, Todsadee and Kameyama (2010) demonstrated that tradable agricultural and food sectors in the Philippines would gain from CEPT. Nevertheless, the research revealed that the potential gain for the Philippines is ambiguous. Simulation results for the period 2004–2010 showed negative real GDP growth, reduced terms of trade, decline in allocative efficiency, and fall in the trade balance in some years.

In contrast, Karim and Othman (2005) showed that the Philippines benefits from AFTA. By creating a big, integrated, and efficient market, AFTA is expected to attract FDI inflows in ASEAN member countries. The study of Karim and Othman (2005) revealed that FDI inflows in the Philippines are positively and significantly affected by AFTA. In addition, the study showed that China's accession to WTO has a negative impact on the majority of ASEAN countries' FDI inflows, which emphasized the importance of further strengthening AFTA.

The Asia-Pacific Economic Cooperation (APEC) was founded in 1989 as an informal ministerial-level dialogue among 12 countries, of which the Philippines is included. The main thrust of APEC is to create an open trade and investment environment in the Asia-Pacific region. As it imposes no binding obligations on its members, APEC has often been the object of criticisms. Thus, it may be hard to isolate the effects of APEC on the

economy (Drysdale & Armstrong, 2009). Nevertheless, Austria (2001) and Medalla, Yap, and Balboa (2009) argued that the Philippines has gained from its participation in APEC. It has established economic ties and networks that not only increased the country's trade and with investment from APEC members but also have helped the Philippines in the aspects of trade facilitation (standards and conformance, customs procedures, intellectual property rights, good governance and transparency, and mobility of business people) and economic and technical cooperation (human resource development, energy, SMEs, agriculture, environment, services, finance, and others).

The Japan–Philippines Economic Partnership Agreement (JPEPA) was enforced in 2008 and is the first bilateral free-trade agreement entered into by the Philippines. Medalla, Vidar-Vale, and Balboa (2010) provided a comprehensive summary of the studies that estimate the impact of JPEPA on the Philippine economy. Depending on the model used and the assumptions on the success or failure of implementing the different aspects of the agreement, JPEPA can generate a gain in real GDP of as low as 0.09% to as high as 3.03%. On the sectoral level, gainers include information, communications and technology (ICT), medical services, tourism, and agriculture, and losers include cement and motor parts and components. Nevertheless, the predicted impact on adversely affected sectors may be prevented if the technical capabilities of these sectors are linked with existing Japanese manufacturing networks. Moreover, Medalla et al. (2010) emphasized the need for improved standards of Philippine exporters, most especially the agricultural sector, in order to benefit from JPEPA. The inclusion of liberalization of trade in services and investments and other trade related issues (i.e., trade facilitation, dispute avoidance, and settlement) are other venues by which Philippines is expected to benefit from JPEPA.

In spite of being a member of the World Trade Organization (WTO), Austria (2001) emphasized the value of regional trade agreements for the Philippines. First, they provide an avenue to overcome trade barriers beyond what can be achieved under the WTO at a faster pace. Second, they enhance the country's competitiveness. Third, they enable the country to address international concerns that can only be addressed at a regional level.

Conclusion and Recommendation

The literature on trade and investment in the Philippines has addressed a variety of issues. A considerable array of studies in the trade literature dealt with the shift in policy throughout the decades from a highly protectionist to a more liberalized regime and the ensuing impact of such a shift to different

aspects of the economy. Many studies found evidence that trade liberalization potentially increases productivity and output growth, improves income distribution, and reduces poverty. Nevertheless, variations in effects across sectors and income and skill groups exist, depending on the trade reform and period of study considered.

Similar to the literature on trade, the literature on foreign direct investment has substantially given attention to policy reforms throughout the decades. A common conclusion is that despite efforts to liberalize FDI policy in the country, the growth of FDI inflows has been unstable and that the Philippines has lagged behind its neighbors in attracting FDI. The unimpressive economic fundamentals of the country is often cited as the primary reason for the country's weak FDI performance. In addition, investment incentives were shown to be costly and ineffective in attracting FDI. Thus, government resources and efforts should be geared toward the improvement of fundamental factors—macroeconomic and political stability, labor productivity, and infrastructure, among others. Meanwhile, the limited studies on the impact of FDI on the Philippine economy verify that FDI has a positive impact on the country's economic growth and domestic private investment.

Trade and investment liberalization paved the way to greater economic integration as manifested by the country's participation in international trade and investment agreements and in international production sharing. However, several studies find some evidence that international agreements can have a negative impact on some sectors of the economy. Nevertheless, most researches conclude that economic gains are generally larger due to the integrated and efficient markets, established economic ties and networks, trade facilitation, and economic and technical cooperation that these agreements provide. With regard to the country's participation in global production networks, the major challenges for the Philippines include the need for the Philippines to move to higher value-added segments of the production chain and the emergence of China as an economic power.

The existing Philippine literature on trade and investment prove that gains from liberalization are not guaranteed. Having sound macroeconomic fundamentals, efficient institutions, appropriate manpower skills, technology, forward and backward linkages, and support industries, among others, are necessary to mitigate the adverse effects and reap the potential benefits of liberalization.

Moreover, the literature suggests that some concerns remain important. For instance, in addition to the use of macro-based data, micro-based data is called for to facilitate more detailed analyses and to formulate better policy recommendations. Likewise, enhanced econometric techniques and models

have become even more essential to better estimate and predict the impact of liberalization on different aspects and sectors of the economy.

The foregoing review of studies has also demonstrated that some important issues remain underexplored. For instance, the Philippine trade literature has often focused on liberalization of merchandise trade but much less on services trade. It is highly recognized that the benefits of services liberalization are felt on many economic activities. Moreover, the services sector has become the largest and fastest growing sector in the Philippine economy and in the world economy. Given these, it is vital that equal, if not greater, attention be given to research on services trade liberalization.

Meanwhile, in the FDI literature, there is a dearth of studies investigating the impact of FDI liberalization on different aspects of the Philippine economy, leaving a considerable area for future research. For example, possible effects of FDI on prices are almost absent from the literature (Lipsey & Sjöholm, 2005). Likewise, research on labor market effects of FDI liberalization is limited. These are very important issues due to their welfare implications and, therefore, must be studied.

The limited number of empirical studies done on the impact of liberalization in other countries on the Philippine economy is likewise notable. The challenge for the Philippines is to address competition for its international market share of traded goods and services and FDI.

As a final note, the liberalization of trade and investment seem inevitable. Therefore, what is vital is to ascertain the circumstances under which greater liberalization and economic integration can enhance the country's economic and social well-being.

Notes

- ¹ A literature map is provided in the Appendix.
- ² In the period of study, period differences in tariff rates barely changed, implying that protection reduced TFP.
- ³ With the aid of the National Statistics Office (NSO) staff.
- ⁴ APEX stands for Agriculture Policy Experiments. The model was developed by Ramon Clarete, Peter Warr, and their associates. It is a neoclassical, Walrasian computable general equilibrium (CGE) model of the Philippine economy with a well-defined production (or supply) sector, as well as a consumption (or demand) sector. See Yap (2002) for more details.
- ⁵ Due to sample size limitations, the authors were only able to do panel cointegration for the entire sample. No specific country analysis was done for the long-run case.

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Appendix: Literature Map

