UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

ELIMINATION OF TRIMS: THE EXPERIENCE OF SELECTED DEVELOPING COUNTRIES

UNITED NATIONS
New York and Geneva, 2007

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UNCTAD/ITE/IIA/2007/6

UNITED NATIONS PUBLICATION
Sales No. E.07.II.D.18
ISBN 978-92-1-112729-4
ISSN 1818-1465

Preface

The World Trade Organization (WTO) Agreement on Trade-Related Investment Measures (TRIMs) came into force in 1995, as part of the Uruguay Round negotiations. The TRIMs Agreement did not define prohibited TRIMs, but its illustrative list included local content requirements, trade balancing requirements and export restrictions. Member States were given 90 days to notify WTO of any existing non-conforming measures. There were in total 43 notifications by 24 developing countries.

After the stipulated transition periods had expired, 10 developing countries under article 5 of the agreement requested extensions of the transition period. By early 2007, virtually all notified TRIMs had been abolished by the countries concerned. Before that, few studies had been conducted to examine the implications of the elimination of TRIMs.

Against this background, the purpose of the present study is to shed new light on this important area. It considers the experience of four countries that notified TRIMs in 1995: Argentina, Mexico, Pakistan and the Philippines. In addition, it covers two countries that, when the project was started, were seeking to accede to WTO: Ethiopia and Viet Nam, the latter of which has now already become a WTO member. The idea of including these two countries was to examine the likely impact of WTO accession on their use of selected TRIMs.

The study constitutes an extension of previous analytical work by UNCTAD in the area of performance requirements, as reported in the *World Investment Report 2003: FDI Policies for Development: National and International Perspectives*. It responds to the decision at the eighth session of the Commission on Investment, Technology and Related Financial Issues (paragraph 5 of the report from that session) that: "The secretariat should also follow up on the work it has undertaken in the World Investment Report 2003, especially on issues of special interest to developing countries."

Furthermore the São Paulo Consensus specified (paragraph 50): "UNCTAD should continue its work on investment, as well as technology and enterprise development, and – through policy analysis, technical assistance and capacity- and consensus-building – assist developing countries in policy formation and implementation in this regard, taking into account developments in the international economic environment. UNCTAD should pay particular attention to the international dimension in order to identify the opportunities for and obstacles to progress in economic development."

The research has benefited from the financial support from the Development Account and offers important findings for Governments and their agencies involved in investment-related policymaking. For example, in the context of promoting linkages, many developing countries have traditionally made use of TRIMs. The six country studies illustrate how the countries concerned have been affected by the elimination of such TRIMs. They also consider possible alternative ways to encourage linkage development.

In the context of this project, a panel discussion was organized in March 2006 during the tenth session of the UNCTAD Commission on Investment, Technology and Related Issues and

back to back with the Annual Conference of the World Association of Investment Promotion Agencies. During the same week, a workshop was organized to discuss the preliminary findings of the case studies.

From a normative perspective, the notion that TRIMs should be disallowed, when individual countries may consider them as useful tools of industrial development and diversification, remains controversial. It has become even more so as developed economies have resorted extensively to such schemes in order to, among other things, build domestic manufacturing capabilities and stimulate production linkages.

The study suggests that the extent to which TRIMs have helped advance the objectives set out has varied considerably, reflecting the specific economic conditions and policy environment of the country using them. In some cases, they have played a role in spurring foreign companies to source more locally in, or enhance their exports from, the host economy. In other instances, the impact appears to have been small or even negative. The effectiveness of various TRIMs has been influenced by a range of factors, including government capabilities, local absorptive capacity of the workforce and domestic enterprises, and the extent to which measures used have been compatible with other industrial and trade policies.

Acknowledgements

This publication was edited by Americo Beviglia Zampetti and Torbjörn Fredriksson under the guidance of Anne Miroux. It is based primarily on background papers prepared for the different chapters by Le Thuc Duc and Tran Hao Hung, Mamo E. Mihretu, David Romo Murillo, Zafar Mueen Nasir, Rene E. Ofreneo, and Diana Tussie and Ignacio Labaqui.

The final version reflects comments received by Joachim Karl, Martha Lara, Dong Jae Lee, Mina Mashayekhi, Theodore H. Moran, Thomas Pollan and Yunsung Tark.

Teresita Ventura did the desktop publishing for the paper. It was edited by Michael Gibson.

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A. The TRIMs Agreement

In general, trade-related investment measures (TRIMs) encompass a broad range of performance requirements and incentives that Governments may place on foreign investors. TRIMs may be used to pursue many different policy objectives, such as (a) promoting exports from the host country (export performance requirements and trade balancing requirements); (b) reducing imports by the foreign investor (local content requirements); (c) advancing economic and social policy goals, including job creation; and (d) technology transfer.

Many countries have used these performance requirements as a tool to maximize the benefits from foreign direct investment (FDI). For instance, local content requirements, which force foreign investors to purchase a proportion of their production inputs from domestic sources, are generally designed to create local jobs and training, promote the transfer of technology and ameliorate trade imbalances.

Throughout the 1970s, Governments of developing and developed countries resorted to performance requirements as a means to counteract the trade distorting practices of TNCs and to promote economic development and growth. These were particularly common in the automotive, chemical and petrochemical, and computer and informatics sectors (UNCTC, 1991).

Foreign investors often objected to the use of performance requirements, which they perceived as unwelcome interference with their investments. Pressure from them led the United States Government to put the issue of performance requirements on the agenda of the 1982 General Agreement on Tariffs and Trade (GATT) ministerial meeting. However, within the GATT there was a deep division between the countries which supported the United States in their quest to have TRIMs placed on the agenda and those which were steadfastly opposed. The United States was supported by other developed countries which were home to corporations with significant overseas investment, including Canada, the European Community and Japan. By contrast, developing and least developed countries (LDCs) were strongly against the inclusion of TRIMs on the agenda because they were considered one of the few bargaining tools they could use to extract concessions and benefits from foreign investors. Moreover, they feared that any new GATT rules which encroached on their investment policy autonomy would ultimately undermine national economic and political sovereignty.

Eventually, the issue of TRIMs was included in the Uruguay Round of trade negotiations. However, as a result of the stark opposition, the TRIMs negotiations turned out as what some observers qualified as the "most frustrating and least productive of the Uruguay Round" because developing countries resented negotiations on the matter, while developed countries had "little leverage to force progress" in this area (Croome, 1995: 138). Not surprisingly, the final agreement did not break any new ground and essentially restated existing GATT obligations. However, even that can be considered an important result from the developed countries' perspective, as it put the spotlight on TRIMs, which previously did not appear to fall within the jurisdiction of GATT, and effectively pushed their elimination – eventually – by means of actual or threatened dispute settlement action. Furthermore, through its illustrative list of prohibited measures, the TRIMs Agreement contributed significantly to more legal clarity.

The Agreement on Trade-Related Investment Measures (the TRIMs Agreement) stipulates that certain measures adopted by Governments to regulate FDI can cause trade-restrictive and distorting effects.[1] The agreement is only concerned with the trade effects of investment measures. It is

not intended to deal with the regulation of investment as such and does not impact directly on WTO members' ability to regulate and place conditions upon the entry and establishment of foreign investment.[2] However, the TRIMs Agreement may have an effect on limiting a country's policy options in regulating foreign investment, once admitted, through the obligations to eliminate prohibited TRIMs measures or through the threat of dispute settlement action.

The stated objectives of the TRIMs Agreement include not only the promotion of the expansion and progressive liberalization of world trade, but also the facilitation of investment across international frontiers.[3] The TRIMs Agreement prohibits the application of certain investment measures related to trade in goods to enterprises operating within the territory of a member. It should be noted that the TRIMs Agreement is concerned with discriminatory treatment of internationally trade goods and quantitative restrictions, and is not specifically concerned with the treatment of foreign legal or natural persons. Thus, the basic substantive provision in article 2 of the TRIMs Agreement prohibits the application of any trade-related investment measure that is inconsistent with the GATT's provisions on national treatment or the elimination of quantitative restrictions.[4] In particular, an illustrative list annexed to the agreement identifies certain measures that are inconsistent with article III.4 or article XI:1 of GATT 1994.[5]

These cover essentially the following types of measures: local content requirements, trade-balancing requirements, foreign exchange-balancing requirements and restrictions on exportation (table I.1). The agreement bans not only TRIMs that are obligatory in nature, but also those whose compliance is necessary in order to obtain an advantage.[6] It applies only to investment measures related to trade in goods. It does not cover trade in services. Measures concerning service industries are addressed by the General Agreement on Trade and Services GATS, which does not contain explicit rules dealing with TRIMs, although these may be subject to specific negotiated commitments.

Table I.1. Prohibited TRIMs contained in the agreement's annex (illustrative list)

Para. 1(a)	Local content requirements	The purchase or use by an enterprise of products of domestic origin or from any domestic source	Internal measure in violation of GATT art. III (national treatment)
Para. 1(b)	Trade balancing requirements	An enterprise's purchase or use of imported products is limited to an amount related to the volume or value of local products that it exports	Internal measure in violation of GATT art. III (national treatment)
Para. 2(a)	Import restrictions generally;	General import restrictions related to product used in local production;	Border measure in violation of GATT art. XI (quantitative restrictions)
	Trade balancing requirements	Import restrictions related to the enterprise's volume or value of local production that it exports	
Para. 2(b)	Foreign exchange balancing requirements	Measures that restrict an enterprise's access to foreign exchange for imports to an amount related to the foreign exchange inflows attributable to the enterprise	Border measure in violation of GATT art. XI (quantitative restrictions)
Para. 2(c)	Domestic sales requirements	The exportation of products is restricted in terms of particular products, volume or value of products, or volume or value of local production	Border measure in violation of GATT art. XI (quantitative restrictions)

Source: UNCTAD.

While the measures illustrated in the annex to the agreement frequently arise in the context of foreign investment policies, there is nothing in the TRIMs Agreement to

suggest that these rules do not apply equally to measures imposed on domestic enterprises. For example, a local content requirement imposed in a non-discriminatory manner on domestic and foreign enterprises is inconsistent with the TRIMs Agreement because it involves discriminatory treatment of imported products in favour of domestic products, regardless of whether there is any discrimination between domestic and foreign investors with regard to the imposition of the requirement.[7]

Export performance requirements are another type of performance requirement often imposed on foreign investors. For various domestic economic policy reasons, these force foreign affiliates to export a larger share of the local output than that motivated by purely profit considerations. Export performance requirements were a sticking point in the Uruguay Round of trade negotiations which led to the TRIMs Agreement, with many developed countries insisting on their inclusion and many developing countries resolutely rejecting it. In the end, neither the TRIMs Agreement nor any other WTO rules forbade the imposition on foreign investors of requirements to export a minimum amount of domestic production.

An important dispute settlement panel ruling had clarified the applicability of GATT to the issue in 1984 in a case pitting the United States against Canada.[8] The panel decision confirmed that existing obligations under GATT were applicable to performance requirements imposed by Governments in an investment context insofar as such requirements involved trade-distorting measures. At the same time, the panel's conclusion that export performance requirements were not covered by GATT also underscored the limited scope of existing GATT disciplines with respect to such trade-related performance requirements. The subsequent Uruguay Round negotiations did not change the situation. The coverage of WTO rules is basically limited to the requirements included in the TRIMs Illustrative List and does not extend to export performance requirements.[9]

Article 5 of the TRIMs Agreement contains provisions for notification of and for transitional periods for the elimination of measures inconsistent with the agreement existing at least 180 days prior to entry into force of WTO. Under article 5.1, States that were members of WTO on 1 January 1995 were required to notify to the Council for Trade in Goods, within 90 days after the date of entry into force of the WTO Agreement, any TRIMs that were not in conformity with the agreement.[10] With regard to transition periods, developed, developing and least developed countries were given, respectively, two, five and seven years from the date of entry into force of the WTO Agreement to eliminate notified TRIMs (article 5.2). Furthermore, upon request, the transition period could be extended for developing and least developed countries that demonstrated particular difficulties in implementing the provisions of the agreement (article 5.3).

Several developing countries forcefully stressed the difficulties in meeting the agreement's obligations. As a result, the WTO General Council meeting in May 2000 agreed to "direct the Council for Trade in Goods to give positive consideration to individual requests presented in accordance with article 5.3 by developing countries for extension of transition periods for implementation of the TRIMs Agreement".[11] At the Doha Ministerial Conference, WTO members took note of the actions taken by the Council for Trade in Goods and urged that council to give positive consideration to possible requests for extension by LDCs. The relevant part of the Doha Implementation Decision reads: "[The Ministerial Conference] urges the Council for Trade in Goods to consider positively requests that may be made by least developed countries under article 5.3 of the

TRIMs Agreement or Article IX.3 of the WTO Agreement, as well as to take into consideration the particular circumstances of least developed countries when setting the terms and conditions including time-frames."[12] After protracted negotiations, extensions were granted to Argentina, Colombia, Malaysia, Mexico, Pakistan, the Philippines, Romania and Thailand until the end of 2003,[13] subject to certain criteria, such as the submission of a phase-out plan for the TRIMs measure.

Beyond the implementation difficulties that prompted the requests for extension of the transition period, the TRIMs Agreement has remained controversial in several respects. Some developing countries have advanced proposals for the modification of the agreement, most recently in the context of the Work Programme on Special and Differential Treatment[14] and of the Decision on Implementation-Related Issues and Concerns. Discussions in this area remain very difficult.[15] However, at the 2005 Hong Kong (China) ministerial meeting, WTO members agreed that LDCs shall be allowed to maintain, for seven years, existing measures that deviate from their obligations under the TRIMs Agreement. For such measures, a notification period of 30 days was set. This transition period may be extended by the WTO Council for Trade in Goods under the existing TRIMs Agreement procedures. Furthermore, LDCs shall also be allowed to introduce new measures that deviate from their obligations under the TRIMs Agreement. The duration of these measures will not exceed five years, renewable subject to review and decision by the Goods Council subject to a general phasing-out deadline by the year 2020.[16]

Debates and disagreements on the relative economic merit of TRIMs, as well as the appropriateness of banning a particular subset of investment measures, do not show any signs of abating. From an empirical perspective, the argument inevitably results in trade distortions not being conclusively proved and views continuing to diverge.[17] The critics stress that "domestic content requirements, and the implicit trade protection associated with imposing such requirements, do not create efficient local industries or promote host country growth. … [R]eaffirming the TRIMS Agreement and adding multilateral prohibitions on joint venture and technology sharing requirements would serve the self interest of developing countries" (Moran et al., 2005).

However, not all agree with this view. It is also argued that "well-conceived performance requirements with clear objectives and effectively enforced are not only able to meet their objectives but may also bring significant favourable externalities to the host countries" (Kumar 2003: 72). Furthermore, it is argued that the abolition of TRIMs may reduce the host country Government's bargaining power and hence the potential gains derived from FDI. In particular, the TRIMs Agreement is seen to impose "restrictions on government actions but no reciprocal restrictions on the actions of multinational enterprises" (Morrissey, 2001: 69). As a result, many developing countries have resisted the obligation to eliminate TRIMs, since they are regarded as policy instruments necessary to encourage industrialization (Hertel et al. 2002: 113–140). Moreover, as the aggregate trade impact of performance requirements has been found to be limited, foregoing this bargaining tool, which may be useful in specific circumstances, is perceived as detrimental in dealings with TNCs.

Hence, from a normative perspective, the notion that TRIMs should be disallowed, when individual countries may consider them as useful tools of industrial development and diversification, remains controversial. This has become even more so, as developed economies have resorted extensively to such schemes in order to, among other things, build domestic manufacturing capabilities and stimulate production linkages.

B. Case study findings

As the discussion remains vibrant, it is important to provide further empirical evidence on the actual impact of TRIMs, and of their elimination, in order to better inform the debate. This is the aim of the present collection of case studies, which focuses on countries that have used TRIMs in the past and, by asking for an extension of the transition period, have shown a particular interest in such policies (Argentina, Mexico, Pakistan and the Philippines), as well as two countries which are either currently negotiating their accession to the WTO (Ethiopia) or have recently joined that organization (Viet Nam).

The studies aim to address, among others, the following questions:

(a) What industries and activities were mainly affected by TRIMs?

(b) To what extent has TRIMs helped advance the objectives for which they were established?

(c) Has the removal of TRIMs enhanced the host country's ability to attract FDI in the relevant industry?

(d) Has the elimination of TRIMs affected the quality of FDI attracted? For example, to what extent has the removal of local content requirements affected the level of local sourcing vis-à-vis imports?

(e) What has been the response from the private sector – local and foreign-owned?

The case of Argentina depicts the interesting experience of the interface between multilateral and regional commitments. Between 1995 and 2000, automobile TNCs invested an estimated $15 billion in the Southern Common Market (MERCOSUR) region. This massive influx of capital transformed the automotive sector in South America's Southern Cone from an obsolete and inefficient one into a modern production base with world-quality products. The Argentinean automotive industry itself went through significant transformation, gradually changing its inward-oriented outlook into an export-oriented one. Exports now constitute 56 per cent of total production, with Brazil remaining (despite some diversification) by far the most important market. By the time the TRIMs Agreement entered into force in 1995, Argentina had abandoned the high tariffs of import substitution. The auto industry stood as an exception.

In this industry, TRIMs were also compounded with high effective protection rates for finished cars. Over time, these measures were used to serve different purposes. In the initial stage (1995–2000), high tariffs for car production were linked to almost duty-free treatment for car parts and components. This policy led to a significant increase and upgrading of FDI, but also to a drastic restructuring of the domestic car part sector. Subsequently, by 2000, when the industry was marked by recession and over-capacity, a more defensive stance was adopted also by way of TRIMs, ensuring that plant closures were not widespread. A third phase ensued as Argentina recovered from the slump and directed its policies towards increasing employment and industrial linkages. In post-crisis Argentina, a new exchange rate restored competitiveness. At the same time, tariffs on car parts increased by 12 to 16 per cent, to match MERCOSUR's Common External Tariff.

Multilateral commitments to eliminate TRIMs were fulfilled in 2003, but proscribed measures under the WTO Agreement have been given a safe haven under the umbrella of the MERCOSUR Automotive Common Policy. The strategy of shifting local content requirement to regional content rules (or rules of origin) and applying a trade balance rule at a regional level allowed Argentina, the study contends, to circumvent the phase-out of TRIMs. In essence, there has been an extension of the

life of TRIMs, albeit now only in the context of regional trade, which is important particularly in the case of the Argentinean automotive industry. Regionalization was able to offset the full blow of the expected phase-out. But substitution naturally led to a new scenario of regionally more active negotiations.

The Mexican case provides interesting lessons regarding the application of TRIMs. These were widely used in several sectors during the import-substituting industrialization efforts that took place after World War II. Their application indeed contributed to the development of the country's industrial base by incorporating Mexican firms into the production chains of TNCs. For most of the industrial sectors where domestic content requirements were applied (e.g. the pharmaceutical and electronics industries), this result, however, proved to be unsustainable. Once these requirements were eliminated, most of the contractual relationships disappeared and the ambitious domestic-content levels set in government plans were never reached.

At the close of the Uruguay Round, the only remaining prohibited TRIMs were local content and trade-balancing requirements affecting the auto industry. For this industry, domestic content rules had become irrelevant, since actual levels were well above those required by the regulation. Hence, these were generally ineffective in achieving long-term and sustained improvements in the performance of companies that at some point benefited from these measures. Trade-balancing requirements, on the contrary, had earlier proven to be pivotal in influencing the decision of major automotive TNCs to include Mexico as an export platform. In this case, they had a positive effect by leading to a change in corporate strategies. Furthermore, trade-balancing requirements had a role to play not only in reducing trade deficits, but in placing Mexico in a more prominent position to source, especially for the United States market.

However, during the past five years, the Mexican auto industry has experienced a deteriorating position reflected in decreased levels of production, exports and employment, combined with increased imports. In the end, improving this crucial industry in a post-TRIMs world will require, the study argues, deepening the local supplier base and targeting specific automotive TNCs for quality or for their willingness to build unique models in Mexico, which can then be exported to other markets.

Pakistan has traditionally used some TRIMs to develop its manufacturing industry as well as protect it from competition. The country maintained links between certain tariff exemptions and local content requirements in a number of industries, including automobiles, electronic goods, electrical goods and machinery. It notified to WTO the elimination of most of those TRIMs in the year 2005. The reason for continuing some of them – especially the deletion programme – was their deemed usefulness. The Government believed that the industries which opted for the programme had significantly benefited from it, while the country as a whole also benefited through job creation and support for underdeveloped areas.

By 2005, most TRIMs notified had been eliminated. Pakistan had removed all programmes relating to machinery and domestic appliances. Difficulties were, however, encountered in phasing out a number of programmes related to the automotive industry. Slow movement on this front aimed to help local vendors prepare themselves to compete in domestic and international markets. According to the Government, TRIMs in this industry have among other things contributed to employment creation, technology transfer, foreign exchange savings, and increased

foreign and local investment. The Pakistani automobile industry is now starting to move into the export market. It is expected that it has reached a level of competitiveness that should enable it to stand on its own feet without government support in terms of tariff and non-tariff measures. The overall effect of the phasing-out of the TRIMs may then spur the industry to enhance its competitiveness even further.

The history of the car industry in the Philippines is also telling with regard to the role played by TRIMs. The Philippines has no car industry of its own. What exists is an auto assembly industry utilizing mostly imported parts in completely-knocked-down or semi-knocked-down packages. In 1973, the Government launched a programme for the "progressive" development of cars, trucks and motorcycles. It mandated investors to observe two TRIMs: increased local content usage and payment of completely-knocked-down imports, partly through export earnings – auto-related or not. The incentive to the original participants – three Japanese joint ventures and two American subsidiaries – was a ban on the importation of completely-built-up (CBU) units. These TRIMs were still in force at the end of the Uruguay Round and continued until mid-2003.

However, three decades of TRIMs failed to produce a Filipino car. The programme ran into difficulties in the first half of the 1980s due to the debt crisis and the ensuing decline in domestic demand. Subsequently, it was watered down as a result of a broad drive to liberalize the investment and trade regime. The completely-built-up ban was replaced by tariff protection, which was initially at 100 per cent but rapidly went down to 40 per cent by 1993; however, tariffs on completely-knocked-down imports fell faster, from 30 per cent in the 1980s to 20 per cent in 1993–94 and subsequently, to 10 per cent in 1995 and 3 per cent in 1996–97. When the Asian financial crisis broke out, both the car assembly and car parts industries were hit by massive closures and layoffs.

There have been only a few winners in the post-TRIMs era – the TNC-assisted producers of parts, e.g. wire harness and transmission, destined for the global market – and those involved in the assembly of certain vehicle models selected by the TNCs based on their own regional and global division of labour. Overall, the "progressive" development of the auto industry, the study contends, was doomed by the rapid liberalization/deregulation programme, poorly-coordinated local content instruments and the general lack of a dynamic and coherent industrial policy to support market development, learning and innovations, which are all necessary to promote technological deepening in the industry.

The case study of Ethiopia, a country in negotiations to accede to the WTO, provides a different picture compared to the case of Viet Nam described later, as the country has hardly used any TRIMs. Ethiopia has been implementing major policy reforms since 1992. These reforms include the liberalization of trade policy, the privatization of public enterprises, financial sector reforms, and deregulation of prices and exchange rate controls. The regulatory regime governing investment in Ethiopia has also undergone significant changes as part of the reform process. The present FDI regime is based on a series of investment proclamations issued between 1996 and 2003. These laws establish (a) which industries are open to FDI; (b) the financial limits and requirements for FDI; (c) the monitoring and reporting requirements; and (d) the available financial incentives. As part of the investment regime reform, the Ethiopian Government has limited the use of performance requirements, including TRIMs, to better attract FDI inflow.

In a further attempt to anchor its trade and investment policy reform process,

Ethiopia in 2003 applied for WTO membership. As part of the accession package, Ethiopia will likely be required to commit itself to implementing the TRIMs Agreement. As Ethiopian FDI policy does not explicitly require foreign firms to meet specific performance goals or guidelines, for instance, in terms of export, foreign exchange, or local content levels in manufactured goods, WTO commitments in this area should not pose a particular challenge. Ethiopia should also enjoy the flexibility provided for in the Hong Kong (China) declaration of December 2005 mentioned above.

The Ethiopian case also confirms the recent general decline in the incidence of performance requirements and the use of TRIMs in Africa. According to trade policy reviews of different African countries conducted by WTO, the majority of African countries do not maintain any TRIMs at present, with a few possible exceptions. This trend, which also goes beyond Africa, can be explained by several factors: (a) the need to comply with WTO commitments; (b) the participation in regional integration and bilateral agreements, which has led certain countries to phase out performance requirements; and (c) the increased competition countries face for FDI inflows.

In the Ethiopian context, however, the limited use of TRIMs is not due to Ethiopia's international commitments. Nor is it a result of Ethiopia's participation in regional integration and bilateral agreements. It is more the effect, the study argues, of the policy shift in 1991 away from central planning. In the context of the new policy direction, encouragement and promotion of investment have become necessary to accelerate the economic development of the country. In Ethiopia, therefore, the reason for the limited and almost non-use of TRIMs is linked to the desire to avoid any measures that would have a deterring effect on inward FDI. TRIMs are not applied for fear that performance requirements may discourage FDI inflows or affect the quality of the investments.

Viet Nam is a country that over time has applied a large number of TRIMs. Hence, this policy area assumed high relevance in the country's WTO accession. The most important set of measures includes the local content requirements, which were used as a condition for licensing foreign investment projects in manufacture or assembly of automobiles, motorcycles and electronic products. For the investments in cane sugar, milk and vegetable oils processing, the requirement has instead been the development of local sources of raw materials. There have been schemes of preferential tariff rates dependent on the ratio of local content that apply to both local and foreign investment enterprises in automobile, motorcycle, mechanical, electric and electronic products or spare parts. As supporting devices to the local content requirements, non-tariff barriers and excise taxes have also been used. Many other TRIMs in Viet Nam served to sustain foreign exchange reserves and control the trade balance. For instance, according to the "foreign exchange surrender requirement", the foreign exchange earners had to sell to State banks a specified portion of their earnings. Furthermore, foreign investment enterprises, producing specified items, must export at least 80 per cent of their outputs. Most of the TRIMs have either been totally eliminated or reduced in their scope of application. Others are loosely implemented.

The case study found that TRIMs mostly failed in the automobile industry. Local content ratios have not been achieved and the automobile spare parts made in Viet Nam are of low quality. In the motorcycle industry, however, foreign enterprises delivered on their local content commitments. Particularly, Honda–Viet Nam has achieved a high local content ratio. Moreover, it has developed strong linkages with local firms. At the same time, it successfully competes with Chinese-made

products and has become an important exporter. Some other motorcycle makers in Viet Nam are also strong competitors. On the other hand, the effect of TRIMs on the production of electronics items has been mixed at best. While electronics exports might have become stronger than without the TRIMs, linkages are weak. Local content is very low in exported products and carries little value added. The obligation to develop local raw materials for processing milk, sugar and vegetable oils made foreign enterprises in Viet Nam less competitive. Failure of this regulation is most apparent for sugar cane production. The high cost of cane input invariably leads to significant differences between world and domestic sugar prices.

Furthermore, the study maintains, TRIMs have not resulted in the expected technology transfers to domestic firms. Overall, they have had moderate positive impacts, if any, on a small group of industries, and these are more temporary than permanent. The possible exception might be the motorcycle industry, which has become quite competitive and for which TRIMs elimination should cause little disruption. The impact of the abolition of TRIMs may also not be important on the local electronics industry, but will significantly affect Vietnamese enterprises in the automobile industry, which will likely undergo a major restructuring. This is even more so for cane sugar producers, where major changes of ownership seem unavoidable.

C. Conclusions

In most of the cases reviewed, TRIMs notification concerned just a few selected industries, most commonly the automotive industry. For many developing countries, the auto industry has been seen as a strategic industry for the promotion of industrialization, employment generation and technological upgrading. In Argentina, Mexico, Pakistan and the Philippines, TRIMs were maintained in this industry long after they had been dismantled in other industries. In the two countries that were in WTO accession negotiations at the time of this study, the situation was somewhat different. Ethiopia – like most African countries – generally had few TRIMs, whereas in Viet Nam TRIMs have been applied in a range of industries, including the automotive industry.

Firm conclusions are difficult to draw from the studies. The extent to which the TRIMs have helped advance the objectives set out has varied considerably, reflecting the specific economic conditions and policy environment of the country using them. In some cases, TRIMs appear to have played a role in spurring foreign companies to source more locally in, or enhance their exports from, the host economy. The auto industry in Mexico and the motorcycle industry in Viet Nam are cases in point. In other instances, the impact appears to have been small or negative. The effectiveness of various TRIMs has been influenced by the clarity of set objectives, the capability of the Governments to implement a given policy, the local absorptive capacity of the workforce and domestic enterprises, and the extent to which measures used have been compatible with other industrial and trade policies.

For example, where the application of local content requirements have not been accompanied by efforts to boost the competitiveness of the local enterprise sector, the removal of the requirements and associated trade protection is likely to force local suppliers out of business. Thus, the findings of this research confirm those of many previous studies, as summarized in an earlier UNCTAD publication (UNCTAD, 2001: 169):

> *"Where [local content requirements are] used carefully, with offsetting measures to ensure that suppliers face competitive pressures and have access to the*

technology and skills they need to improve their capabilities, they can foster efficient suppliers. Where used in a protective setting, with few pressures to invest in building competitive capabilities, they can result in inefficient suppliers that saddle the economy with high costs, outdated technologies or redundant skills."

While the use of certain TRIMs is no longer an option in most WTO member States, such objectives as promoting industrialization, improving the trade balance and encouraging local sourcing remain of high priority to developing-country Governments. This underlines the importance of exploring policies that can help achieve these objectives, without violating internationally-agreed principles. What is to be perceived as an efficient mix of policy measures in this context has to be considered for each country. There is no blueprint that can be applied across the board.

In some cases, development objectives previously promoted through the use of local content requirements are now partly encouraged through the rules of origin of regional trading areas. In Argentina, the effects of the removal of WTO-notified TRIMs were partially offset by regionalization under the MERCOSUR Automotive Policy. The rules of origin under the North American Free Trade Agreement (NAFTA) also stipulate certain levels of regional content that have to be met for a product to benefit from the free trade between Mexico, Canada and the United States.

An important objective of policymakers seeking to promote industrialization and greater levels of local sourcing by foreign companies operating in their economies is to develop policies that can help strengthen the productive capacity and competitiveness of local firms. In Mexico, for example, the Ministry of the Economy's Competitiveness Programme for the Automotive Industry aims to promote the development of a greater number of suppliers, to modernize the regulatory framework, and to simplify administrative procedures. This involves various forms of support to help auto part suppliers increase their specialization in production, foster the development of clusters, increase technological capabilities and human resources training, and increase market diversification. Greater cooperation among the industry, the Government, and academia in the design and implementation of a successful integral development plan for the industry is also seen as crucial.

In Viet Nam, the Government is exploring alternative, WTO-compliant policy measures. With respect to the automobile, motorcycle and electronic industries, it has outlined a plan for the provision of incentives to attract FDI in projects aimed at the production of supporting materials and boosting the production of high-quality components and spare parts. It is also contemplating setting up special industrial zones for both domestic and foreign enterprises producing supporting materials and components for these industries.

The results of the cases reviewed in this volume should be seen as preliminary in nature. Firstly, due to a lack of hard data, it has not always been possible to assess fully the impact on the trade and investment behaviour of foreign firms. Secondly, it is difficult to distinguish the impact of a certain performance requirement from that of other policy and institutional factors influencing the outcome. Thirdly, the period of time elapsed since the elimination of TRIMs has been relatively short. Thus, there is scope for further analysis to understand better how the use of various performance requirements may help or hinder the fostering of economic development.

Notes

[1] For a recent commentary on the Agreement, see Lara de Sterlini, 2005: 437–483. See also Koulen, 2001.

[2] This is in contrast to the General Agreement on Trade in Services (GATS), which covers some aspects of investment liberalization, although limited to the area of services.

[3] See TRIMs Agreement Preamble.

[4] "The TRIMs Agreement essentially interprets and clarifies the provisions of article III (and also article XI) where trade-related investment measures are concerned. Thus, the TRIMs Agreement does not add to or subtract from those GATT obligations, although it clarifies that article III:4 may cover investment-related matters." Report of the Panel, *European Communities – Regime for the Importation, Sale and Distribution of Bananas*, WT/DS27, 25 September 1997, para. 7.185.

[5] Other measures beyond those specifically listed could be claimed to be TRIMs in violation of article 2.1 of the TRIMs Agreement. This would entail showing that the measure at issue is a TRIM inconsistent with the provisions of article III or article XI of GATT 1994.

[6] The Report of a WTO Panel, *Indonesia - Certain Measures Affecting the Automobile Industry*, WT/DS54/R, WT/DS55/R, WT/DS59/R, WT/DS64/R, 2 July 1998 made it clear that "A simple advantage conditional on the use of domestic goods is considered to be a violation of article 2 of the TRIMs Agreement even if the local content requirement is not binding as such" (paragraphs 14.88–14.91).

[7] On this point see Panel Report on *Indonesia – Autos*, paragraph 14.73.

[8] The panel considered a complaint by the United States regarding certain types of undertakings which were required from foreign investors by the Canadian authorities as conditions for the approval of investment projects. These undertakings pertained to the purchase of certain products from domestic sources (local content requirements) and to the export of a certain amount or percentage of output (export performance requirements). The panel concluded that the local content requirements were inconsistent with the national treatment obligation of article III:4 of the GATT but that the export performance requirements were not inconsistent with GATT obligations. The Panel emphasized that at issue in the dispute before it was the consistency with the GATT of specific trade-related measures taken by Canada under its foreign investment legislation and not Canada's right to regulate foreign investment per se. See Canada - Administration of the Foreign Investment Review Act ("FIRA") (BISD 30S/140, 1984).

[9] However, it is important to stress that a requirement to export is inconsistent with article 3.1(a) of the WTO Agreement on Subsidies, if it is combined with a subsidy within the meaning of article 1 of that agreement.

[10] The WTO General Council in April 1995 decided that States that had not been members of WTO on 1 January 1995, but were entitled to become original members within a period of two years after 1 January 1995, should make notifications under article 5.1 within 90 days after the date of their acceptance of the WTO Agreement. All notifications pertaining to the TRIMs Agreement are recorded in Report (2005) of the Committee on Trade-Related Investment Measures, G/L/752, of 25 October 2005.

[11] WT/GC/M/55, annex II, the third bullet point.

[12] Section 6 of the Decision of 14 November 2001 on Implementation-related issues and concerns (WT/MIN(01)/17 of 20 November 2001).

[13] 30 June 2003 in the case of the Philippines and 31 May 2003 in the case of Romania.

[14] Under Paragraph 44 of the Doha Ministerial Declaration.

[15] Report (2005) of the Committee on Trade-Related Investment Measures, G/L/752, of 25 October 2005.

[16] Doha Work Programme, Ministerial Declaration, WTO doc. WT/MIN(05)/DEC, 22 December 2005, annex F.

[17] For a review of the evidence, see Trade-Related Investment Measures and other Performance Requirements – Joint Study by the WTO and UNCTAD Secretariats, G/C/W/307, 1 October 2001 (Part I) and G/C/W/307/Add.1, 8 February 2002 (Part II). See also UNCTAD (2003).

II. Argentina

A. Introduction

By the time that the WTO TRIMs Agreement provisions entered into force in 1995, Argentina had abandoned its import substitution strategy and dismantled most industrial policy measures.[1] The automotive industry stood as an exception so Argentina's TRIMs commitments to WTO were seen to have crucial implications for the system of incentives in the sector.

This chapter analyzes the impact of TRIMs commitments in Argentina's automotive industry. Section B provides an overview of trends in FDI flows together with a brief description of the country's legal framework for foreign investment. Notifications of TRIMs to the Council of Trade in Goods are analyzed in Section C. Sections D and E provide an account of the evolution of the automotive industry since the early 1990s. Section F assesses the consequences of the removal of TRIMs for the automotive industry, and section G concludes.

B. Regulatory framework and recent trends in FDI

During the 1990s, Argentina became one of the main recipients of FDI among the emerging economies. The boom in FDI was intimately linked with a major shift in development strategy. Reforms entailed the liberalization of both trade and capital account, and a far-reaching privatization programme, which privatized all the major State-owned companies, including public utilities and even the oil-producing firm YPF. This section analyzes the country's regulatory framework for FDI and depicts recent trends in FDI inflows with a focus on industries in which TRIMs have been applied.

1. Legal framework

FDI in Argentina is regulated by the Foreign Investment Act 21382 (1976) and the Executive Decree 1853/1993. The former guarantees foreign investors "the same rights and obligations that the Constitution and laws accord to domestic investors, subject to the terms of this law and the terms contemplated in special or promotional regimes" (article 1). Foreign investment is defined as:

a) All capital contributions belonging to foreign investors and used in economic activities in Argentina; and
b) Acquisition of all or part of an existing domestic company's capital by foreign investors (article 2).

The law distinguishes between two types of firms: domestic companies of foreign capital and domestic companies of domestic capital. The former comprise all those firms located in the country in which physical or juridical persons domiciled abroad own directly or indirectly more than 49 per cent of the capital, or directly or indirectly control the number of votes necessary to prevail in stockholder meetings (article 3, paragraph 3). On the other hand, domestic companies of domestic capital are those in which physical or juridical persons domiciled within the country own at least 51 per cent of the capital and control the votes required to prevail in stockholder meetings. The 1976 law represented a turning point, as it eliminated all general restrictions on FDI. Not only did it grant equal rights to foreign investors, it also permitted the free remittance of profits. According to one study (Bouzas and Chudnovsky, 2004: 5), "the 1976 Foreign Investment Act shifted the policy focus from FDI control to FDI promotion".

Executive Decree 1853/1993 reaffirmed the principles contained in Act 21382 allowing foreign investors to invest in the country without prior approval, while also guaranteeing their right to repatriate capital and remit earnings abroad. The decree also derogated the dispositions of the Technology Transfer Act (22426) of 1981 merely stipulating that "all legal deeds entered into between independent companies, plus any made between a domestic company with foreign capital and the company (or a subsidiary therefore) that directly or indirectly controls it… for informational purposes" (article 8) be registered at the National Institute of Technology.

Deregulation in the early 1990s made a significant contribution to the promotion of FDI. The Economic Emergency and State Reform laws passed during the first months of the Carlos Menem administration (1989–1999) further relaxed the remaining restrictions on FDI. The Economic Emergency Act (23697) removed the authorization requirements in the information, electronic and telecommunication industries, while the State Reform Act (23696) set the framework for the divestiture process which led to massive inflows of capital.

The 1994 Constitution granted international obligations precedence over domestic regulations. As a consequence, international commitments became an integral part of the regulatory framework for FDI. International obligations concerning FDI stem from two sources: commitments undertaken in regional or multilateral agreements, and bilateral investment treaties (BITs).

In the first case, two WTO agreements stand out, the TRIMs Agreement and the General Agreement on Trade in Services (GATS). Both were signed and ratified by the Government. In addition to the obligations arising from these WTO agreements, the Government also sought to encourage FDI through BITs, aiming at providing investor protection. During the 1990s, 51 BITs were signed, in many cases granting investors the right to bypass domestic courts and file complaints directly before international arbitration tribunals.

Within the realm of MERCOSUR, Argentina in 1994 signed the Colonia Protocol on Reciprocal Promotion of Investments. The protocol grants investors from member States most-favoured nation and national treatment standards. With the transitory exception of the automotive industry, performance requirements are banned by the treaty. In case of an investor–State dispute, firms can opt between local courts, international arbitration or a regional device, which to date has yet to be developed.

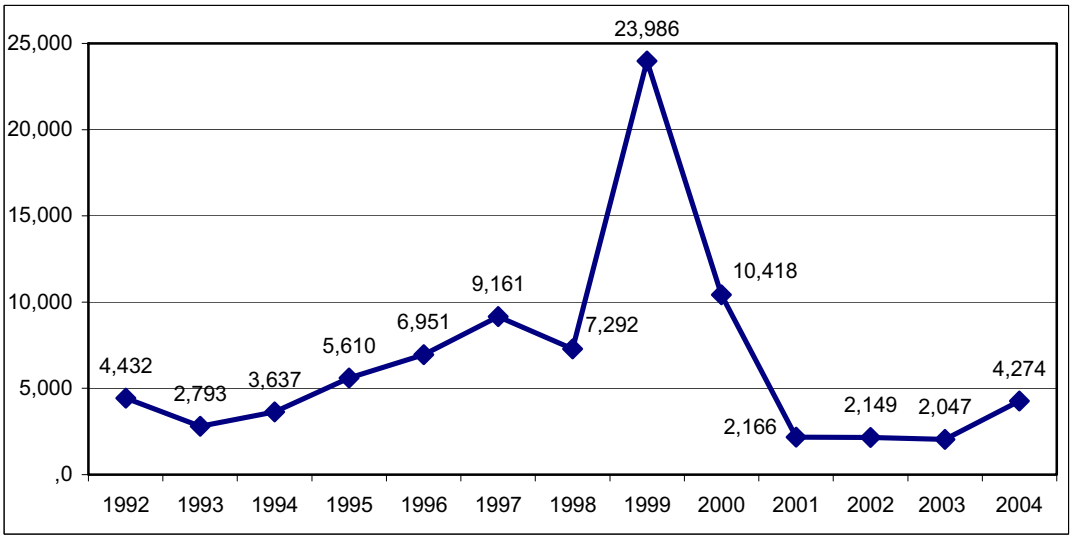
2. Recent trends in FDI inflows

The embracing of market-oriented reforms and a favourable international financial environment turned Argentina into a large recipient of both FDI and portfolio investment. FDI jumped to an average of $8 billion in 1996–1998, from an average of $4 billion in 1992–1995, reaching a peak of $24 billion in 1999 (Argentina: Ministerio de Economía, 2003).[2]

The economic crisis at the end of the 1990s led to a decrease in both portfolio investment and FDI. In the case of Argentina, the impact of the crisis was two-fold. First, it drew the economy into a four-year recession; secondly it led to a speculative attack against Brazil (at that time Argentina's major export destination). The devaluation of the Brazilian *real* in January 1999 deepened Argentina's recession. Exports from Argentina plummeted with the loss of relative competitiveness and the slowdown in the Brazilian economy. The increasing uncertainty among market operators about the Government's ability to maintain the convertibility of the

Argentinean peso and meet its debt payments resulted in a drop of capital inflows in 2000–2002 (figure II.1). Default and devaluation in 2001 resulted in an 11 per cent decline of GDP in 2002.

Figure II.1. FDI 1992–2004
(Millions of dollars)



Source: Argentina Ministry of Economy.

FDI inflows had initially favoured the utilities sector – notably electricity, gas and water – reflecting interest in the privatization process. As shown in table II.1, during the first half of the 1990s, electricity, gas and water were major recipients of FDI. Manufacturing received about one third of total inflows of FDI between 1994 and 1997. However, after 1998, its share decreased.

Table II.1. FDI inflows by sector 1993–2004
(Millions of dollars)

	Year											
Industry	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Petroleum	277	502	436	1 046	105	1 313	17 830	2 689	796	995	-221	2 067
Mining	-6	17	140	682	72	11	15	48	103	138	69	198
Manufacturing	858	1 798	2 186	2 776	3 308	1 147	1 950	1 487	49	988	1 229	1 221
Electricity, gas and water	1 116	124	1 111	681	1 527	932	951	446	197	109	33	170
Commerce	42	339	318	523	150	699	742	51	662	-23	241	-3
Transportation/communication	-19	245	634	145	845	260	714	3 870	167	-538	-355	-202
Banking	418	160	512	747	2 366	1 757	746	382	235	-9	246	158
Others	106	452	272	350	788	1 173	1 038	1 445	-42	489	645	665
Total	2 793	3 637	5 610	6 951	9 161	7 292	23 986	10 418	2 166	2 149	1 887	4 274

Source: Argentina Ministry of Economy.

Within manufacturing, the automotive industry was a large recipient during the 1990s, surpassed only by the chemical and plastics industry and by foodstuffs in selected years (table II.2). FDI in the automotive sector was especially high between 1995 and 1997. The impact of the recession in 1998 is evidenced by the sharp drop in FDI between 1997 and 1999. In 1999, there was a negative inflow of $313 million, which was attributed mainly to the decline in economic activity following the devaluation of the Brazilian currency. The resulting decrease in labour costs also led to the switching of several lines of production to Brazil, both in the automotive and components industries.

Table II.2. FDI flows by sector within the manufacturing industry, 1992-2004
(Millions of dollars)

	Year												
Sector	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Foodstuff, beverages and tobacco	384	338	1 014	793	405	360	256	1 192	476	6	-133	268	419
Textiles and leather	-	39	-18	80	15	36	-5	-49	-12	-37	36	16	-18
Paper	-102	27	31	119	375	335	89	15	91	-195	78	41	91
Chemistry, rubber and plastics	217	350	325	792	937	770	232	762	695	395	171	538	-51
Cement and ceramics	33	47	26	33	20	51	306	0	-25	-35	12	55	2
Metal industry	-120	26	245	-31	86	569	96	-18	74	-20	819	246	122
Machinery and equipment	-152	-32	60	8	165	106	111	360	-64	-47	-75	-62	51
Automotive and transportation	373	64	116	392	774	1 082	65	-313	253	-17	80	42	606
Total	634	858	1 798	2 186	2 776	3 308	1 147	1 950	1 487	49	988	1 145	1 221

Source: Argentina Ministry of Economy.

C. Argentina's TRIMs notifications

All TRIMs notified by Argentina, as provided for by the WTO Agreement, were related to the automotive industry. Amidst a decade characterized by the dismantling of industrial policy instruments, the automotive industry (mainly vehicle-producing firms) stood as a solitary exception, under a special regulatory regime, which not only protected it from foreign competition, but also offered a particularly generous treatment to investments. As a result of the entry into force of the TRIMs Agreement in 1995, Argentina notified the so-called "Argentinean Automotive Regime".[3] By the same token, on 21 March 1997, the Government of Argentina made an addendum to the 1995 communication, effectively notifying the changes introduced in the Automotive Regime by Decree 33/1996.[4]

According to the TRIMs Agreement, trade-related performance requirements included in the Automotive Regime and its amendments were to be eliminated by 31 December 1999, at the end of the five-year transition period. The authorities had planned to replace the provisions in the context of MERCOSUR's Common Automotive Policy. By that time, both Argentina and Brazil had special automotive regimes which infringed the TRIMs Agreement. According to MERCOSUR regulations, they were supposed to dismantle these regimes by 2000 and liberalize automobile trade within the bloc. However, negotiations with Brazil towards meeting this goal had by then proven fruitless. The adverse external financial environment of the late 1990s complicated the negotiations. The competitiveness gains made by the Brazilian industry after its devaluation added

tension to an already difficult negotiating environment. As the 1999 deadline approached (see below), making use of the provisions of article 5.3,[5] Argentina applied for a seven-year extension of the duly notified TRIMs until 31 December 2006 (WTO document G/C/W/176).

The Government justified its request for extension on the grounds that "because of its contribution to export earnings, domestic output, employment and technological progress and its other important economic effects, the Argentine automotive and auto parts industry is regarded as an economically strategic sector". [6] Argentina's communication acknowledged the progress made by the automotive industry in the 1990s under the framework of the Automotive Regime, but noted also that "the consolidation of the industry is not yet complete" and that "various factors have affected the process which, by the end of the period envisaged in the Argentinean Automotive Regime, should have led to its being placed on a firm footing".[7]

The submission specifically mentioned (a) the 1998 recession affecting domestic output; (b) the change in relative prices due to the devaluation of the Brazilian currency in January 1999, with a negative toll on exports; and (c) the need to conclude the MERCOSUR Common Automotive Policy. Finally, Argentina pledged to phase out gradually all the inconsistent measures and progressively eliminate the trade balance mechanisms within the requested seven-year extension period. The trade balancing conditions, together with an *ad valorem* 35 per cent tariff, would remain the sole instrument of trade protection for automobiles.

On 31 July 2001, the Council of Trade in Goods issued a decision agreeing to extend the transition period until 31 December 2001 and granting Argentina the possibility of requesting an additional two-year extension. [8] Such a request was supposed to be grounded on a clear statement of the difficulties in implementation, and had to be communicated to the Council before 31 August 2001. In addition, the council mandated that the request comprise a description of the steps taken to eliminate remaining TRIMs: a phase-out plan for eliminating the outstanding TRIMs before 31 December 2003 and the submission of periodic progress report.

Prior to the 2001 economic collapse, the authorities requested the two-year additional extension of the transition period, but showed discontent over the rejection of the seven-year extension request.[9] The need to "consolidate the development of an internationally competitive automotive industry and to conclude the MERCOSUR Common Automotive Policy" was once again the reason used by the Government to justify its request. Furthermore, the authorities stressed the worsening of the situation depicted in the original request caused by the continued recession. In exchange for the extension of the notified TRIMs, Argentina committed to comply with the obligations arising from the MERCOSUR automotive policy i.e.:

(a) The liberalization of trade within the bloc;
(b) Bilateral negotiations with third countries conducive to a further liberalization; and
(c) The elimination of the (almost) duty-free treatment granted to auto parts, raising the rate to meet the common external tariff (CET) in accordance with the schedule presented in table II.3.[10]

Table II.3. CET Convergence schedule for auto parts

	2000	2001	2002	2003	2004	2005	2006
CET 14%	7	8.8	9.3	10.5	11.7	12.8	14
CET 16%	8	9.3	10.7	12.0	13.3	14.7	16
CET 18%	9	10.5	12.0	13.5	15.0	16.5	18
Tariff differential	50%	41.9%	33.6%	25%	16.9%	8.6%	0%

Source: World Trade Organization.

The Government also pledged to eliminate the local content requirement by 31 December 2003, as required by the Council in its prior communication. With its 5 November 2001 Decision, the Council granted a two-year extension of the transition period (WTO document G/L/497).

A year later, on 19 December 2002, Argentina informed the council of the progress made in the dismantling of remaining TRIMs. [11] Referring to the usefulness of local content requirement for the recovery and strengthening of the auto parts sector, the Government communicated that local content requirements had been made "more flexible in terms of both the actual requirement and the tariff benefit". This greater flexibility was two-fold:

(a) The level of the local content requirement was reduced from 30 per cent to 20 per cent. In addition, a further reduction was planned.

(b) The range of goods was reduced. While in the past, local content requirements applied to all vehicles in the automotive sector (cars, light utility vehicles, buses, lorries, chassis, tractors, agricultural machinery, self-propelled road-going vehicles and auto parts for all the vehicles mentioned), after the inception of the MERCOSUR Common Automotive Policy, requirements were to be applied only to cars, light utility vehicles and corresponding auto parts.

The Government also compressed the above timetable for convergence of preferential tariffs on auto parts, which was brought forward by one year. These changes were embodied in the agreement signed with Brazil on 26 September 2002, registered as Additional Protocol XXXI to Economic Complementation Agreement 14 under the umbrella of the Latin America Integration Association (LAIA).

D. The automotive regime and the MERCOSUR automotive policy

1. The automotive regime

Recession and hyperinflation in the late 1980s drove the automotive industry towards its worst plunge in three decades, with annual production dropping to slightly above 100,000 units. Against this critical backdrop and acknowledging the industry's economic relevance both in terms of output and employment, the Government adopted a set of measures to stimulate the industry. It released Decree 2226/1990 which:

(a) Established a balanced trade requirement scheme which should reach a 1/1 ratio in 1993;

(b) Granted tariff benefits for car parts and components, and lifted local content requirements for manufacturers holding a trade surplus;

(c) Allowed import quotas of vehicles;[12] and

(d) Set new caps on imported content.

This decree sought to overturn the closing of several plants and massive layoffs. It was the first of a set of attempts to encourage internationalization and diminish the trade deficit.

The following year, concomitantly with the adoption of a new stabilization programme, the Government brokered an agreement with the whole automotive sector, including not only manufacturers and component producers, but also dealers. The goal was to encourage domestic demand through price reductions. As a result of the *Acta de Concertación Para el Crecimiento*, signed in March 1991 by all the mentioned parties:

(a) The price of new vehicles was lowered by 33 per cent in relation to December 1990 prices;
(b) The Government temporarily eliminated internal duties and National Highway Fund taxes on vehicles;
(c) Dealers accepted to reduce their commissions; and
(d) Auto parts producers reduced prices to manufacturers by 16 per cent.

This six-month agreement was renewed in October 1991 for another semester. In this context, the Government released Decree 2677/91, the Automotive Regime, which:

(a) Classified vehicles into two categories: A and B. Category A included cars and small passenger vehicles with a maximum load capacity of 1,500 kilos. Trucks and passenger vehicles with a load capacity over 1,500 kilos corresponded to the B category.
(b) Established a 60 per cent and a 58 per cent local content requirement for vehicles in categories A and B, respectively. Until 1994, these percentages could be averaged between different models of a same category. After 1994, local content could only be averaged between different units of each specific model. In addition, until 1994, local content requirements for new models were lowered to 50 per cent.
(c) Imposed balanced trade requirements for car manufacturers whose exports had to equal their imports. However, the regime itself relaxed this requirement. Twenty-five per cent of the components exported by independent producers and 30 per cent of investments made by manufacturers in locally produced machinery and equipment were computed as exports. In addition, exports of vehicles were multiplied by a factor of 1.2.
(d) Allowed the import of vehicles by locally established producers with a 2 per cent tariff, provided they were balanced by exports.
(e) Set a 2 per cent tariff for non-Latin American Integration Association (LAIA) imports of components and a 22 per cent tariff for the import of vehicles made by private consumers.

This scheme was to a great extent the result of the negotiations undertaken with firms and unions under the scope of the "*Comisión para el Acuerdo y Restructuración de la Industria Automotriz*", created in 1990 (Etchemendy, 2001). The regime, which would be in force until 31 December 1999, applied a two-fold mechanism for the generation of extraordinary rents for vehicle producers: a market reserve ensured by the restrictions to the import of vehicles by non-established firms, and a balanced trade requirement that granted preferential tariffs for imports of completely built-up units and components. Clearly, the Government sought to boost an industry that traditionally entailed large-scale investments and was a major source of employment.

A general fall in interest rates and the negotiated drop in prices gave way to a sales boom (see below). The remarkable increase in demand was met not only by domestic production, but also by imports. As a result, many producers were unable to comply with the balanced trade requirements. In order to avoid penalties for violations of the import cap, the Government in 1994 introduced some amendments through Decree 683/1994, which provided firms a generous scheme for the cancellation of penalties. In addition, it raised the rate of investments computed as exports from 30 per cent to 40 per cent, broadening the concept of "investments" to include offices and buildings (Vispo, 1999; Llach, et al., 1997).

The automotive regime was evidently biased in favour of the vehicle-producing firms. [13] A further modification to the automotive regime in 1996 by Decree 33/96 established the so-called "auto parts producers regime". The regime introduced a balanced trade scheme for auto parts with the goal of favouring the import of extra-MERCOSUR parts with a 2 per cent preferential tariff and the possibility of meeting the local content requirement over a three-year period. As to the balanced trade requirements, the decree established that:

(a) Exports of auto parts would be multiplied by a factor of 1.2;
(b) Exports of auto parts ceded by other firms would be multiplied by 1.1; and
(c) Investments in domestic capital goods would be computed as exports at the rate of $1=$1.4, then decreasing gradually to $0.7 in 1999.

In addition, the decree contained modifications for the balanced trade requirements set for vehicle-producing companies. The new regulations computed the following items as exports:

(a) All the purchases of matrixes and presses by vehicles or auto parts producers;
(b) The increase in exports by capital goods-producing firms with respect to 1993, which could be transferred to vehicle firms as exports of their own; and
(c) The increase in local content in respect to the previous year. The positive differential in domestic added value would generate credit in the firm's trade balance.

This last amendment was geared towards providing incentives to the auto parts industry. However, it was also a response to the implementation in Brazil of a set of measures that resembled the Argentinean regime, with even further incentives to attract FDI. Both unilateral initiatives, the Brazilian regime and the amendment of the Argentinean Automotive Regime, took place as preemptive measures amidst efforts to put together the MERCOSUR Common Automotive Policy.

The Argentinean regime envisaged a $200 million trade surplus for automobile manufacturers for 1992–1994. However, by the end of 1994 there was instead a deficit amounting to $2.1 billion. This imbalance was caused by the regime's lack of adjusting mechanisms to deal with infringements to the balanced trade targets set by automobile producers. In addition, booming domestic demand forced the Government to sacrifice the trade balance objectives of the Automobile Regime in order to keep prices down. Meanwhile, firms were easily able to meet the 60 per cent local content requirement (Llach, et al., 1997; Vispo 1999).

In order to curb the flaws of the Automotive Regime, the Government passed Resolution 450/92, which compelled firms to provide quarterly information on the accomplishment of balanced trade targets. The United Nations Industrial Development Organization (UNIDO) was requested to audit the accomplishment of the investment plans presented by automobile producers

(Vispo, 1999). The audit, conducted by Coopers and Lybrand (Vispo, 1999) on behalf of UNIDO, found several infringements and anomalies that resulted in fines of $150 million for car manufacturing.[14]

In 1996, Decree 683/96 amended the regime setting the fines for past infringements to balanced trade requirements and establishing the procedure for future breaches. Accordingly, firms had to present a one-to-three year balanced trade plan. Its approval by the Government would be subject to an investment plan. Decree 33/96 changed the formula and methodology for the computation of local content for each particular model instead of as an average of the whole production as envisaged by the initial regime. Despite these changes, "the surveillance of local content requirements became increasingly relaxed".[15]

2. The MERCOSUR automotive policy

Any assessment of the use and impact of TRIMs in the Argentinean automotive industry has to take into account the substitution effect in the context of MERCOSUR. The MERCOSUR automotive policy contains strict rules of origin – akin to local content requirements established at the regional level. Automotive trade is the backbone of MERCOSUR. By the late 1990s it had grown significantly and represented about a quarter of total bilateral trade (see figures II.2 and II.3).

As MERCOSUR's transition period came to an end in 1995, in the context of the Ouro Preto Protocol negotiations, bloc members adopted Decision 29/94, which outlined the policy for the automotive sector for the following five years:

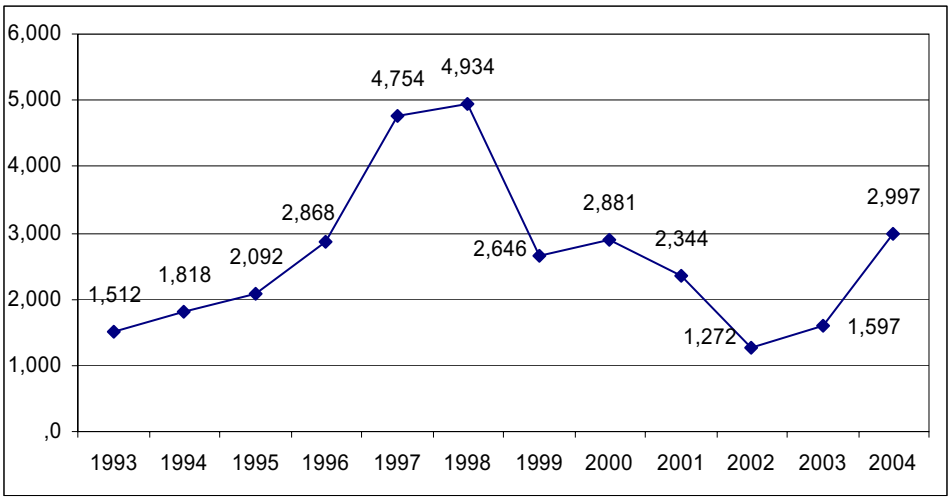
(a) A common automobile regime should be adopted no later than 1 January 2000.

(b) The new regime would permit complete intraregional free trade for all products in the automotive sector, establish a CET and eliminate all trade-distorting incentives.

(c) A technical committee was created to negotiate a framework for the industry.

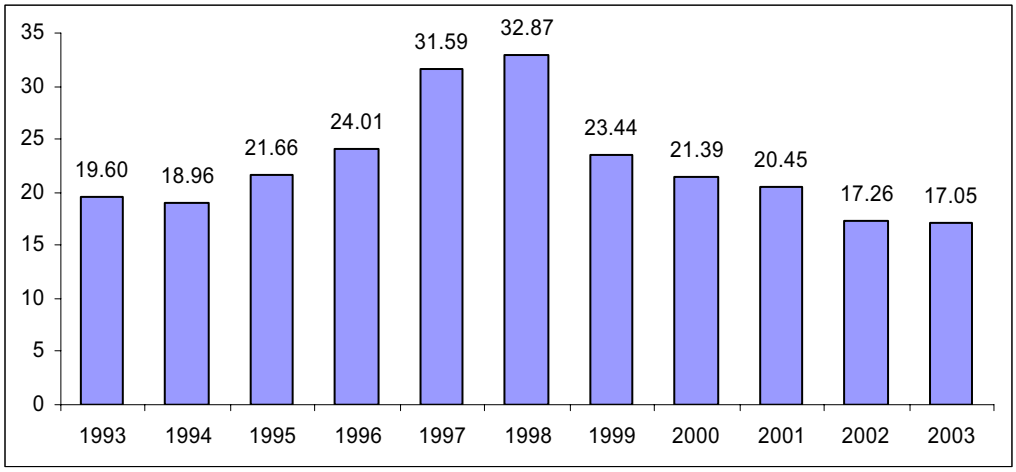
(d) Governments should refrain from adopting unilateral restrictive measures.

Figure II.2. Argentina–Brazil automotive trade 1993–2004
(Millions of dollars)



Source: Centro de Estudios para la Producción (CEP), Argentina Ministry of Economy.

Figure II.3. Bilateral automotive trade Argentina–Brazil
(% of total bilateral trade)



Source: Own elaboration on the basis of data from the Argentina Ministry of Economy.

Hereafter, the last issue would be the subject of intense negotiations, especially after Brazil launched its own automotive regime. Brazil's Executive Decree 1024/1995 applied a 70 per cent tariff for non-MERCOSUR vehicle imports. Furthermore, it granted a preferential tariff scheme for the import of raw materials and capital goods by vehicle producers, and set balanced trade requirements allowing firms to compute investments and the purchases of capital goods as exports. Finally, the decree established a 60 per cent local content requirement.

A year later, in January 1996, Argentina and Brazil negotiated a new agreement which maintained balanced trade requirements and established 31 December 1999 as the deadline for the elimination of the national regimes. Before that date, both countries were supposed to outline a common policy for the bloc. However, the entry into force was postponed to 2004. The need to comply with the provisions of the TRIMs Agreement, which mandated a phase-out before January 2000, put pressure on negotiators. The Argentine request for an extension filed before the Council of Trade in Goods gave some extra time and allowed Argentina and Brazil to strike an agreement in June 2000.

However, shortly after the announcement of the agreement, tensions between Argentina and Brazil resurfaced over the 30 per cent domestic content clause. According to Argentina, this figure had to be net of imported pieces, and thereby it should not consider imported parts of locally manufactured completely knocked-down kits. This methodology was meant to provide relief to its components industry, which was being badly hit by the dual impact of the local recession and the Brazilian devaluation.[16]

Argentina and Brazil were eventually able to forge a new deal. MERCOSUR'S automotive policy would include both methodologies for the calculation of local content: by process and by net content. If the computation followed the method by process, minimum local content would be set at 44 per cent of the price of the vehicle (37 per cent for commercial vehicles); if the "piece-by-piece" methodology was used (the one demanded by Argentina), net content had to be at 30 per cent (25 per cent for commercial vehicles).

The Agreement on MERCOSUR'S Automotive Policy was finally signed at the Florianopolis Summit in December 2000. The final arrangement in essence established regional TRIMs under the following terms:

(a) The value of every vehicle or auto part exported from Argentina to Brazil must be compensated with a similar amount imported from Brazil in order to enjoy duty-free treatment.

(b) Argentina and Brazil were allowed to deviate from balanced trade requirements by 5 per cent in 2000, 7.5 per cent in 2002 and 10 per cent in 2003.

(c) Intra-MERCOSUR exports above the annual deviations would be subject to the payment of 70 per cent of the CET.

(d) Auto parts exports exceeding the export cap were to pay 75 per cent of the CET.

(e) A 60 per cent regional content requirement was set for passenger cars, trucks, trailers and buses. In the case of auto parts, the regional content was calculated according to MERCOSUR'S general rules-of-origin requirements.

(f) New models had to comply with a 40 per cent regional content during their first year, rising to 50 per cent in the second, and 60 per cent in the third.

(g) A 30 per cent local content requirement was set for vehicles produced in Argentina and destined for the regional market.

(h) For imports of passenger cars, small commercial vehicles, buses, trucks and trailers from third countries, the CET was set at 35 per cent. Tractors, farm equipment and highway construction mechanisms were subject to a 14 per cent CET.

(i) A product made by a company that received any type of investment incentive from a federal, state, provincial and/or municipal Government after 1 January 2001 would be deemed to be non-MERCOSUR in origin. This provision did not apply to manufacturers that received benefits before the cut-off date.

Despite these agreements, as the Argentinean crisis deepened during 2001, tensions re-emerged. Argentina sought to advance the entry into force of regional free trade,[17] a request that was rejected by Brazil. Finally, the collapse of the peso parity in 2002 and the regaining of competitiveness diminished controversies for a while. Presidents Duhalde from Argentina and Cardoso from Brazil amended the MERCOSUR automotive regime in September 2002. The amendments were embodied in the Additional Protocol XXXI to Economic Complementation Agreement 14. The protocol incorporated the "Agreement about the Common Automotive Policy between Argentina and Brazil" into the Economic Complementation Agreement 14. Argentina and Brazil agreed to the following measures:

(a) Move the elimination of differential tariffs for auto parts one year forward in line with the schedule presented in table II.4.

Table II.4. CET convergence schedule for auto parts agreed in September 2002

	2000	2001	2002	2003	2004	2005
CET 14%	7	8.8	9.3	10.9	12.5	14.0
CET 16%	8	9.3	10.7	12.5	14.3	16
CET 18%	9	10.5	12.0	14	16	18
Tariff differential	50%	41.9%	33.6%	22.3%	10.8%	0

Source: Latin American Integration Association.

(b) Reduce the Argentinean local content requirement from 30 per cent to 20 per cent and schedule its gradual phasing out by 31 December 2005 as indicated in table II.5.

Table II.5. Phase-out schedule for the Argentinean local content requirement scheme (%)

Year	2002	2003	2004	2005
Argentinean local content	20	20	10	5

Source: Latin American Integration Association.

(c) Relax the maximum permitted deviation over the exports-imports as shown in table II.6.

Table II.6. Maximum permitted deviation over the exports–imports limit 2001–2006 (%)

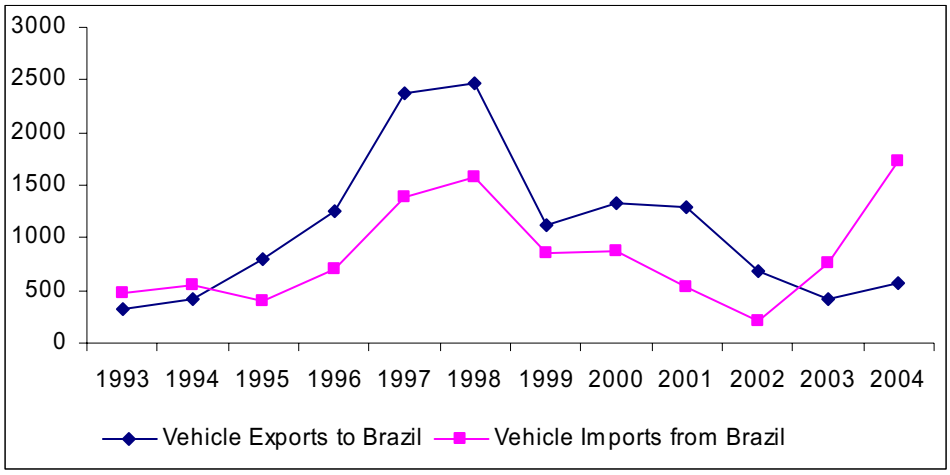
Year	Maximum Export	Minimum Import	Deviation Coefficient over Exports
2001	123.0	77.0	1.6
2002	133.3	66.7	2.0
2003	137.5	62.5	2.2
2004	141.2	58.8	2.4
2005	144.4	55.6	2.6
2006		Free Trade	

Source: Latin American Integration Association.

Notwithstanding the sharp devaluation of the Argentinean currency during 2002, the trade surplus in the sector dropped as domestic demand picked up. Figure II.4 shows that despite the overvalued exchange rate of the 1990s, Argentina had achieved a higher surplus before the devaluation. In fact, as a result of the strong recovery of the economy during 2003 and 2004, the surplus reverted to a deficit.

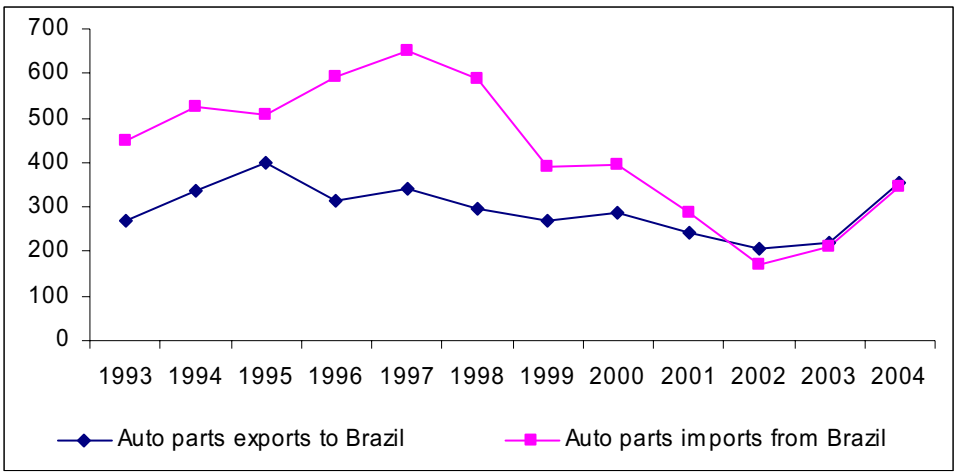
In the case of auto parts, the opposite picture emerged (figure II.5). During the 1990s, the auto parts industry showed a permanent trade deficit with Brazil, because Brazilian parts were computed as domestic for the local content requirement. The MERCOSUR automotive policy sought to address this situation and established a transitory 30 per cent Argentinean content requirement. This requirement, together with the competitiveness gains achieved due to the peso devaluation, allowed the industry to obtain a slight trade surplus in 2002 and in the following years.

Figure II.4. Vehicle trade with Brazil 1992-2004
(Millions of dollars)



Source: CEP, Argentina Ministry of Economy.

Figure II.5. Auto parts trade with Brazil 1993-2004
(Millions of dollars)



Source: CEP, Argentina Ministry of Economy.

In the light of the increasing deficit in vehicle trade with Brazil, the Government now insists on the delaying of the entry into force of free trade within MERCOSUR until 2008.

E. The automotive industry in Argentina

The automotive industry is considered to be of strategic importance to Argentina. It contributes considerably to export earnings and is an important source of industrial employment, with backward and forward linkages. To a large extent, industrial output is heavily dependent on the fate of this industry. As of 2005, 10 automobile manufacturers were established in the country, with a joint capacity to produce 850,000 vehicles per year (table II.7). About 42,000 workers were directly employed by such firms. However, if the whole automotive sector is considered, including dealers and auto parts producers, this figure rises to 60,000 workers.

The auto parts industry comprises around 390 firms. About 74 per cent of them are located in Cordoba and Buenos Aires.[18] As will be shown below, this industry went through a dramatic restructuring during the

Table II.7. Automobile firms established in Argentina, 2005

Firms	Location of the Plants	Models produced
Daimler-Chrysler	González Catán, Buenos Aires	Sprinter
Fiat	Córdoba, Córdoba	At present it is not producing vehicles. Plants are focused on the production of engines, gear levers, etc.
Ford	General Pacheco, Buenos Aires	Escort, Focus, Ranger
General Motors	Rosario, Santa Fe Córdoba, Córdoba	Corsa, Grand Vitara, Grand Blazer
Iveco	Ferreyra, Córdoba	Iveco 120-720, Powerstar
PSA Peugeot-Citroën	Villa Bosch, Buenos Aires	Berlingo, Peugeot 206, Peugeot 307, Peugeot Partner
Renault	Santa Isabel, Córdoba	Clio, Kangoo, Megane
Scania	Colombres, Tucumán	At present it is not producing vehicles. Plants are focused on the production of engines, gear levers, etc.
Toyota	Zárate, Buenos Aires	Hilux
Volkswagen	General Pacheco, Buenos Aires	Polo, Caddy

Source: Own elaboration on the basis of STRAT-Consulting and ADEFA.

1990s, not only due to the transformations of the local economy but also because of shifts in the strategy of multinational automobile manufacturers towards greater internationalization of their value chains (Llach, et al., 1997; Kosacoff, 1998).

Argentina was a latecomer in the global automobile market. The Big Three – Chrysler, Ford and General Motors, which had set up assembly plants in the early 20th century – had mostly driven by the cost savings obtained through the export of semi-knocked down or completely knocked down kits compared with those of completely built-up vehicles. As a result, in the years prior to the depression, Argentina was the second largest destination of United States automobile exports after Canada (O'Keefe and Haar, 2001). Only in the 1950s and 1960s did the industry experience a remarkable development in the country. In line with the tenets of the import substitution industrialization strategy pursued by Latin America in the post-war period, the Governments of Argentina, Brazil and Mexico provided incentives for the establishment of automobile producers behind high import tariffs. In this vein, the Regime for the Promotion of the Automotive Industry approved by the Frondizi administration in 1959 laid the conditions for the establishment of foreign firms and the development of the industry. In addition, FDI was granted access to preferential credit mechanisms. As noted above, high local content requirements were also set.

Despite the stop–go cycles that marked Argentina's post-war growth pattern, the automotive industry registered considerable growth during the 1960s and 1970s. The pattern of production involved integrated vehicle factories that included all the major operations – stamping, casting, forging, machining and assembly – effectively contrasting with the pattern of simple assembly plants observed in Chile, Colombia, Peru and Uruguay. The remarkable growth of automobile production led to the development of a large auto parts industry which mainly comprised local small and medium-sized firms. Altogether, by the early 1970s, the automotive industry had become the most dynamic manufacturing industry and one of the most important sources of employment (Vispo, 1999). Local content requirements and the high tariff protection enjoyed by automobile manufacturers were highly relevant for the development of both branches of the automotive industry, which, prior to the onset of the military dictatorship, had achieved a high level of technical maturity and, stimulated by government tax incentives, had started to adopt a regional outward orientation (Schvarzer, et al., 2003).

The situation changed after 1975 and most specifically under the military dictatorship (1976–1983). In 1979, the military Government passed Law 21932 and Decree 201/79 for the car industry. It allowed lower local content and devised a balanced trade scheme for auto parts. Auto part producers were displaced as suppliers of car manufacturers due to the greater flexibility in the local content requirements introduced by the 1979 regulations, and hence moved towards supplying the market for replacements. Local auto part manufacturers, which had up to then enjoyed the benefits of local-content requirements and high tariffs, had to face foreign competition and were often displaced by foreign suppliers (Vispo, 1999). The overvalued exchange rate applied until 1981 aggravated the problems generated by the greater openness established in the new framework. Altogether, the automotive sector was badly affected by a sharp decline throughout all of the 1980s. Vehicle producers opted to close down or reduce the scale of their activities.[19]

Since 1990, the industry has passed through different stages. In the first phase (1991–1994), production and sales recovered from a sharp decline in sales and output. In the second phase (1995–1998), the industry

experienced a second boom. Recovery was pinned to domestic demand, but it was also driven by the remarkable increase in exports, largely to the Brazilian market. A third phase began in 1999 with the recession that concluded with the dramatic collapse in 2002. This was characterized by a drop in both domestic and foreign demand and the continued appreciation of the currency. In addition, there was a significant contraction in FDI, caused by rising labour costs and the pessimistic forecast on the evolution of the domestic market. Finally, the strong economic recovery since 2003 signaled another phase characterized by the resumption of both domestic and foreign demand, but without reaching the record levels of the 1990s.

1. Phase 1: Domestic demand-driven boom (1991–1994)

Beginning with the implementation of the convertibility plan and until the Mexican crisis of 1995, the industry experienced a remarkable recovery both in terms of output and sales. The production of vehicles increased by 190 per cent over the period, reaching the industry's historical record in 1994 with a production of more than 408,000 units (table II.8).

Table II.8. Vehicle production 1990–1994

Year	Passenger and light commercial vehicles	Commercial vehicles	Total
1990	81 107	18 532	99 639
1991	114 113	24 845	138 958
1992	220 502	41 520	262 022
1993	286 964	55 380	342 344
1994	338 355	70 422	408 777

Source: Llach, et al., 1997.

Car producers that had left the country staged a comeback hand in hand with firms without a previous presence. The enacting of MERCOSUR also spurred business interest (Llach, et al., 1997; Bastos Tigre, et al., 1998).

Despite the sharp increase in both sales and output, it was not all good news. While an improved economic environment benefited the car firms, the auto parts sector went though a drastic process of restructuring. Mergers, acquisitions and strategic agreements led to a transformation "significantly reducing the number of firms and increasing internationalization" (Kosakoff, 1998: 47).

The bias in the automotive regime had imposed a high tariff on finished vehicles, while at the same time practically shedding all the protection for the auto parts producer. The bias was especially harmful for independent auto parts firms, since it led car producers to increase their reliance on controlled auto part companies with the two-fold objective of supplying lines of production and improving their trade balance with higher exports (Vispo, 1999). The new regulatory framework also stressed the turn to greater foreign content of vehicles (Kosakoff, 1998).

2. Phase 2: Outward led-growth (1995–1998)

The Argentinean economy was badly hit by the exogenous shock generated by the devaluation of the Mexican currency of December 1994. During 1995, GDP fell by almost 4 per cent and unemployment jumped to 18 per cent. The automotive industry was not immune to the general evolution of the economy. Production fell in 1995, driven by a decline in domestic demand (table II.9). However, the decrease in domestic demand was partially offset by growing vehicle exports to Brazil.

Table II.9. Vehicle production 1995–1998

Year	Passenger and light commercial vehicles	Commercial vehicles	Total
1995	226 656	58 779	285 435
1996	269 439	43 713	313 152
1997	425 224	21 082	446 306
1998	435 003	22 954	457 957

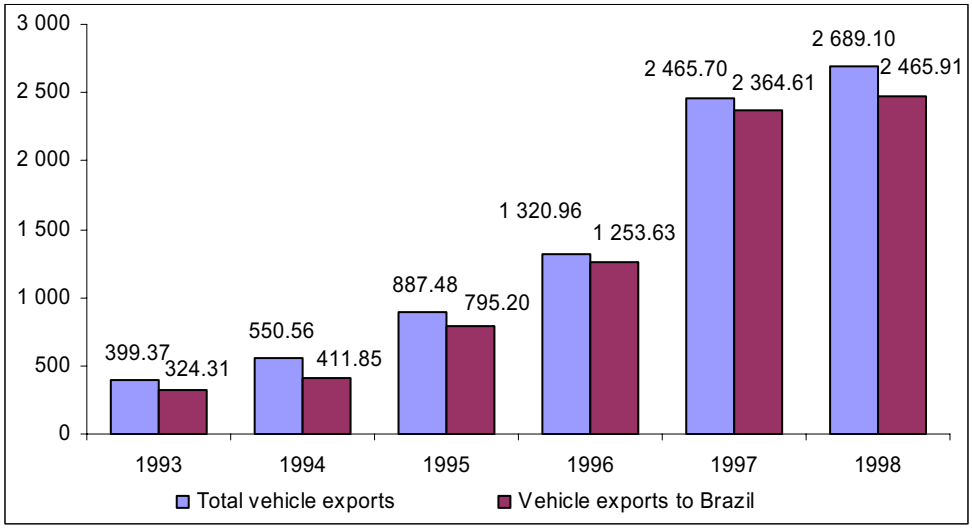
Source: Llach, et al. (1997) and ADEFA.

The main feature of this phase was the consolidation of a regional production platform in line with the investment plans of TNCs. The strengthening of MERCOSUR made it strategically attractive for automotive firms seeking to boost regional capacity.[20] The regulatory framework adopted both by Argentina and Brazil (Decision 29/94 analyzed in section D.2) favoured the development of this regional production platform. The stabilization of the Brazilian economy after the "Plan Real", allowed a significant increase in the exports of vehicles (figure II.6).

The favourable scenario resulted in a significant increase in investments. The re-entry of players that had left the country, as well as the fresh establishment newcomers, continued. Fiat, Peugeot and Renault regained control of their operations (Strat Consulting–Grupo Unidos del Sud, 2002).

The shake-out of the auto parts industry deepened during this phase. The inception of new models and the need to meet an increasingly sophisticated demand led to the phase-out of old models. A large number of auto part firms, unable to meet the higher standards set by manufacturers, were pushed out to the replacement market. Automobile firms took advantage of the greater trade openness and the benefits of MERCOSUR.[21] The trend towards concentration became more pronounced, reducing the number of direct suppliers (Llach, et al., 1997).

Figure II.6. Vehicle exports to Brazil/total vehicle exports (1993–1998)
(Millions of dollars)



Source: CEP, Argentina Ministry of Economy.

3. Phase 3: Recession and adjustment (1999–2002)

Argentina entered into a downward spin as from the second semester of 1998. The Brazilian economy faced a nebulous situation characterized by an overvalued exchange rate, a large fiscal deficit and an equally large current account deficit. These structural weaknesses were crowned with a public debt that had leapt from 28 per cent of GDP to 50 per cent of GDP in four years (Cardoso, 1999). As capital fled, the economy started to slow as from the second half of 1998. Despite the assistance of the international financial institutions, in January 1999 Brazil let its currency float and a sharp devaluation ensued.

The impact of the Brazilian crisis on the automobile industry was manifold. Firstly, the decline in economic activity resulted in a sharp contraction of demand, which obviously affected automobile exports. Secondly, the devaluation represented an immediate competitiveness gain for the Brazilian economy. The new exchange rate translated into lower labour costs in Brazil, which became more attractive for FDI. The downward spiral in Argentina progressed further and extended until the collapse of December 2001/January 2002 (table II.10, figure II.7).

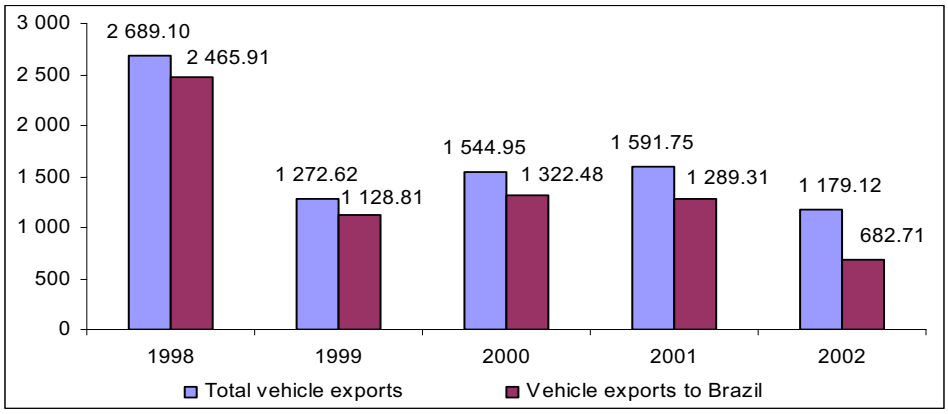
Table II.10. Vehicle production 1999–2002

Year	Passenger and light commercial vehicles	Commercial vehicles	Total
1999	291 277	13 532	304 809
2000	325 037	14 595	339 632
2001	227 089	8 488	235 497
2002	153 118	6 283	159 401

Source: ADEFA.

Production plummeted as both local and foreign demand weakened. Lower labour costs induced auto part producers to switch their operations to Brazil. A fresh run of fiscal incentives provided by Brazilian states further provoked plants in Argentina to close and move to Brazil.[22] At least 30 auto parts manufacturers either shut down their plants, reduced their scale, cancelled investments or moved to Brazil between 1999 and 2001 (Strat Consulting–Grupo Unidos del Sud, 2002).[23] Car manufacturers reduced their scale of production, partly suspended personnel, closed some plants, and cancelled investments. When the Argentine meltdown finally came, production plunged further to record low levels.

Figure II.7. Total vehicle exports/vehicle exports to Brazil (1998-2002)
(Millions of dollars)



Source: CEP, Ministry of Economy.

4. After the crisis

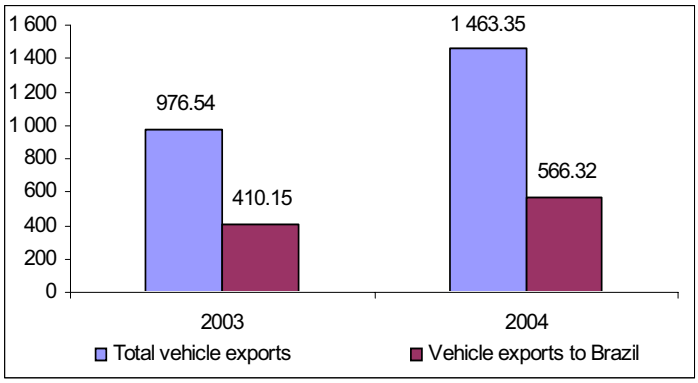
After an 11 per cent free fall of GDP, the Argentinean economy bounced back during 2003 and 2004, achieving a 9 per cent increase in GDP for two years in a row. The automotive industry also regained part of its dynamism (table II.11). Despite the recovery, which even resulted in the return of some of the auto part firms that had migrated to Brazil, the industry remains below its 1998 peak, in terms of both output and demand. There has been a turn to increased export diversification with a significant reduction of the share of exports destined to Brazil (figure II.8).

Table II.11. Vehicle production 2003–2005

Year	Passenger and light commercial vehicles	Commercial vehicles	Total
2003	160 583	9 039	169 622
2004	244 343	16 059	260 402
2005	299 205	20 550	319 755

Source: ADEFA.

Figure II.8. Vehicle exports to Brazil/total vehicle exports (2003-2004)
(Millions of dollars)



Source: CEP, Ministry of Economy.

Prospects for the industry have turned around. By June 2005, production had grown beyond the more optimistic forecasts, and a 20 per cent increase was expected for 2005. Furthermore, as both domestic and foreign demand recovered, laid-off and suspended workers were gradually rehired, showing a 30 per cent increase in employment since 2003. All manufacturers are expected to continue increasing their workforces (*El Cronista*, 12 July 2005). Table II.12 outlines some new projects in the portfolios of the terminals. The production of the following new models is worth highlighting: PSA Peugeot Citröen (307), Volkswagen (new versions of the Polo and Caddy models), Renault (Dacia–Logan), Daimler–Chrysler (new sprinter), Toyota (new Hilux) and Ford (Ranger 2005).

Table II.12. Recent investment decisions

Firm	Project
Scania	Is investing $20 million in the expansion of its Tucumán plant. The firm is also considering the production of chassis for buses.
Toyota	Has invested $37 million for the launch of a new passenger vehicle in its Zarate plant. Has invested $270 million to produce the Hylux pickup over 2002–2005.
Fiat	Has announced investments for $50 million, although it will only resume local manufacturing if the MERCOSUR market continues to expand.
Volkswagen	At present, it is executing a $200 million investment project for the manufacturing of a new model in its Pacheco plant.
Peugeot-Citroen	Is investing €150 million in the manufacturing of two new models.

Sources: *La Nación* (17 June 2005)*; El Cronista (20 October 2005).*

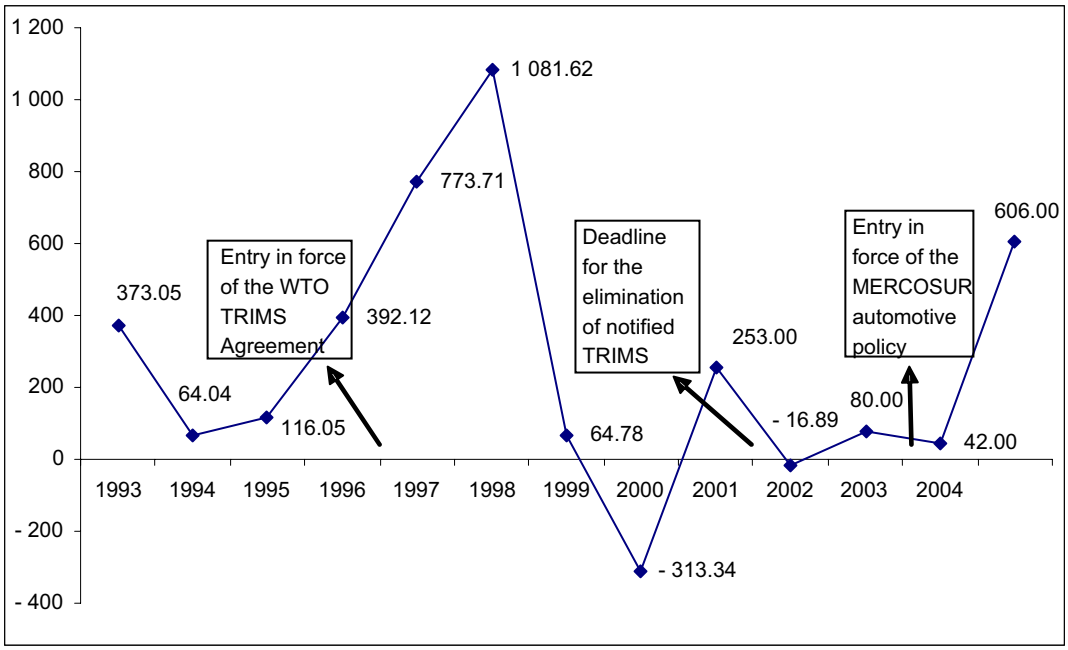
F. Assessing the impact of the TRIMs phase-out

This section analyzes the impact of the removal of TRIMs in Argentina. Particularly, it attempts to assess the extent to which TRIMs affected the magnitude and quality of FDI inflows. Two caveats are in order. Firstly, TRIMs were applied to serve different purposes over time. Secondly, the fact that a good deal of the basic elements contained in the Argentinean automotive regime (due for elimination under the

TRIMs commitments) were regionalized through the MERCOSUR Common Automotive Policy offset the impact of the phase-out. As a result, there was an extension of the life of the TRIMs under regional rules of origin and regional trade balance requirements. Such substitution did not eliminate the measures but naturally led to a new scenario more active on a regional than a multilateral level.

Throughout the 1990s, the automotive industry was a large recipient of FDI. Figure II.9 shows the evolution of FDI in the automotive industry between 1992 and 2003. FDI soared between 1993 and 1997. After that, investment dropped sharply.

Figure II.9. FDI flows in the automotive industry 1992–2004
(Millions of dollars)



Source: Own elaboration based on data from the Argentina Ministry of Economy.

The shape of TRIMs changed over time to serve different industrial purposes. The regulatory moves were accompanied by adjustments to the effective rate of protection. Argentina signed the WTO TRIMs Agreement as part of the commitments undertaken in GATT's Uruguay Round. The TRIMs agreement became binding for Argentina in 1995, when Congress passed Law 24,425 which ratified the Marrakesh Agreement.

Although the automobile sector was continuously consulted over the issue so as to reach a satisfactory settlement over the drafting of the TRIMs agreement, remaining out of its scope was never considered a feasible option. At the time of negotiation, investment was growing at a rapid pace and modernization was under way. The transition period gave both Government and business the breathing space to think there was enough time for retooling so as to build new state-of-the-art factories. Buying time was of the essence. One scholar[24] highlights the reputation effect thought to be embodied in international agreements:

> "*The Government's main goal was to acquire reputation and it was prone to overact. Of course, on certain issues there was no choice. Some of the conditions stemming from the multilateral*

system were impossible to avoid or delay single-handedly."

At the same time, the same expert dismisses the idea that government negotiators might have taken into account industrial policy considerations during the negotiations leading to the signature of the TRIMs agreement. In this fashion, he states:

"*None of these issues were in the minds of the negotiators during the 1990s. In the best case, there was a concern to capture investment flows without an ancillary microeconomic strategy at all. These subjects were best left to the firms themselves.*"

The testimony of Javier Tizado, former Secretary of Industry, reinforces this picture. Tizado highlights the fact that the level of protection granted by the Government to the automotive industry could only have been justified if it resulted in a spurt of investment, technology, know-how and growth accruing to the bulk of Argentina's industrial sector, and led to greater integration of the country's automotive production. However, during the 1990s:

"*Argentina suffered a dramatic process of productive disintegration. The production of engines practically ceased, and the manufacturing of chassis diminished considerably.*"

As a result of the greater exposure of the auto parts industry to international competition, the higher standards set by automobile manufacturers, the currency overvaluation and the favourable treatment provided at its onset by MERCOSUR regulations, local sourcing levels of automobile manufacturers decreased dramatically during the 1990s. Historically, the ratio between the importation of auto parts to manufacturers' total purchases of auto parts[25] had been 20 per cent, achieving a historical minimum of 5 per cent during the 1989 hyperinflation crisis. This trend was reversed during the 1990s. The ratio rose to 40 per cent by 1994, and peaked at 77 per cent in 2000. Then it decreased to 60 per cent in 2001 (Schvarzer et al., 2003).

Despite the neglect of a microeconomic strategy, the managed-trade regime led to a regional division of labour whereby the more specialized niche cars came to be manufactured in Argentina, while mass-consumption models were produced in Brazil. At the same time, the rosy scenario led to overinvestment in the industry. Between 1995 and 2000, automobile TNCs invested an estimated $15 billion in the MERCOSUR region. This massive influx of capital transformed the automotive sector in South America's Southern Cone from an obsolete and inefficient production base – surviving on outmoded model lines with a poor reputation for quality and competitiveness – into a modern production base, manufacturing contemporary models and, in a growing number of cases, world-quality products. In Argentina, local consumers in 1991 had only 21 different models to choose from, some of which were 30 years old; by 1997, they could choose from 60 distinct products, including the most modern cars sold on the world market (O'Keefe and Haar, 2001: 21).

As long as the markets in both countries were expanding, this worked well and auto trade within MERCOSUR expanded rapidly, with greater intra-MERCOSUR specialization by firms, yielding efficiencies. However, the Argentinean industry became very focused on the Brazilian market. When demand weakened and the devaluation of the Brazilian *real* meant that Argentina was suddenly less attractive as an export base, it meant major problems for the auto industry.

The automotive regime contained three particularly attractive features: access to the enlarged market, high protection levels for finished goods and the possibility

for established car manufacturers to import vehicles with a 2 per cent tariff, as long as they were balanced by exports. The strength of these instruments has led some experts to cast doubt on the benefits brought by the regime in terms of industrialization and transfer of technology:

> "*[Established car manufacturers] were granted a market protected by a 35 per cent tariff as well as six years to benefit from the import business.*"[26]

The incentives lay in capturing the rents of protection at both ends in an expanding market. There were no incentives to develop a chain of suppliers or any other development objectives. Negative effective protection cornered components producers (where employment creation was greatest) out of the market, indicating the scant attention to the issue.

The second round was ushered in by recession, the shakeout in the components sector and a generally more defensive spirit. When the regional market stagnated in the late 1990s, overcapacity led to fears of a drastic shakeout that could result in mergers, joint production agreements, the elimination of duplicative factories, and/or some manufacturers' being driven completely out of the market. In this round, the Government used the TRIMs umbrella to negotiate an agreement with Brazil to effectively regionalize measures. Hence, the managed-trade features ensured that any plant closures would not be confined to Argentina. The regime maintained the 35 per cent tariff and incorporated both balanced trade and local content requirements, which had previously been embodied in the respective Argentinean and Brazilian automobile regimes, although with certain modifications. Both regional and national rules of origin were applied.

Investment projects assumed a 20 to 25 per cent excess capacity. The reasons behind this level of overinvestment lay in the threshold required for each project and the reliance of the subsidiary on the development of a new project to remain in the country. Even in good years, such as 1997 and 1998, this excess capacity entailed problems in terms of costs of production and created pressures for tariff protection (Kulfas et al., 2002).

Automobile investments in Argentina and Brazil between 1995 and 1997 had projected a market of 3 million to 3.5 million vehicles per year. When the economy collapsed in 2001, a structural overcapacity was magnified:

> "*Firms had assumed that they had to operate with a 20–30 per cent permanent excess capacity. Besides, exports outside the regional market had not been envisaged. The 35 per cent tariff was generous enough to finance that inefficiency level. Suddenly, they found out that they had to work with a spare capacity of 50 per cent rather than 20 per cent. I believe that there was this strong belief in the industry that there had to be an adjustment. In this vein, there were two possibilities: (a) the disappearance of one big player – in this regard, nobody wanted to leave the regional market since they had all committed large investments; (b) the dismantlement of the operations – the Argentinean industry fitted perfectly. It was exactly that: 20–25 per cent of the installed capacity.*"[27]

If in the initial round TRIMs served as a means of upgrading FDI, by 2000 a more defensive purpose ensued when the scenario of overcapacity backfired. The risk to Argentina was that of becoming a periphery to the Brazilian "core". The defensive strategy of the Government bore fruit. Both the recovery of domestic demand after 2002 and the Government's ability to delay complete liberalization of intra-bloc automobile trade, together with the

maintenance of high tariff levels, prevented the fleeing of both manufacturers and auto parts producers to Brazil. Still, the fact that the industry is at present working with an excess capacity of 50 per cent tends to constrain further investments in the sector.

The third act unrolled gradually, as Argentina recovered from the slump with a watchful eye on employment and industrial linkages. The exchange rate that followed the crisis restored competitiveness. When applied tariffs on car parts were jacked up from 2 per cent to match the CET (at 14–18 per cent), the pincer movement which had risked cannibalizing the sector was lifted (see section E). At the same time, to reverse the bias on car parts, the MERCOSUR Common Automotive Policy set a 60 per cent regional content rule of origin (applied on balanced trade). The regional content was split by Argentina and Brazil on a fixed basis.

The Government's decision to carve out a national allocation on the regional content requirement is best explained as an acknowledgment of the need to reverse the bias against car parts and its potential industrial linkages. Altogether, these measures provided a strong boost to a sector which, after a significant shakeout in the preceding period, now shows good performance indicators, together with higher concentration and internationalization rates. The transformation was led by three players (Kulfas et al., 2002; Maceira, 2003):

(a) Firms partially or totally owned by car manufacturers, which were the main suppliers of the modern plants opened in the early 1990s;
(b) Large international independent firms that are suppliers of automobile firms at an international level; and
(c) Brazilian firms that established in the Argentinean market as part of a strategy of regional expansion.

The latter two groups of players entered into the market once the 2001–2002 turmoil settled, through the acquisition of competitive local firms with established records as suppliers to the automobile manufacturers. Smaller locally-owned firms were displaced to the third and fourth rung of suppliers (Maceira, 2003).

The effects of the removal of WTO-notified TRIMs were partially counterbalanced by regionalization under the MERCOSUR automotive policy. The Government's main tools to keep established firms operating within the country had been the high tariff protection level granted by MERCOSUR's CET, the balanced trade requirements laid out by the MERCOSUR automotive policy, and to a lesser extent the local requirement, which sources assume is not honoured in practice.[28] In order to reduce the sector's mounting trade deficit with Brazil ($1.5 billion in 2005), the Government announced three measures:

(a) In mid-2005, a subsidy programme with funds from the Inter-American Development Bank for $100 million for auto parts was announced. Decree 774/2005 also sought to boost the auto parts industry, providing that automobile manufacturers purchasing local auto parts will receive an 8 per cent tax reimbursement for a three-year period. This provision would apply to auto parts with up to 30 per cent of imported content used for the production of new automobile platforms and new automotive items such as engines, gear levers, chassis and buses.
(b) Since non-MERCOSUR exports need not comply with either local or regional content requirements, competitive firms were prompted to strengthen export diversification. In this vein, most of the investment projects announced during the course of the last two years were linked to the internationalized part of the

industry (*Clarín, El Cronista,* various issues).

(c) The Government announced its decision to stick to balanced trade in MERCOSUR, thus delaying the entry into force of full sectoral trade liberalization within the bloc due to have taken place in 2006. This announcement was seen as device to retain the presence of established firms operating in the country.[29]

In sum, as TRIMs under WTO rules finally became illegal for Argentina in 2003, they were transmogrified to regional rules on balanced trade and rules of origin, the latter split on a fixed basis per country. The 35 per cent tariff on finished cars (coupled with a maximum tariff of 18 per cent on parts) was seen as a strong incentive to retain established firms. The regional agreement expired at the end of 2005. At the time of preparing this report, the scene was set for the fourth and final act of negotiations with Brazil. Brazil will hold out for a time but an agreement will be signed. Argentina holds full most-favoured nation liberalization (hence wiping out Brazil's preferential access) as a trump card. The price tag is the balanced trade ratio. Since the MERCOSUR market is too valuable for Brazil to lose, there is likely to be a continuation of the balanced trade ratio. The Argentine strategy also includes pursuit of free trade agreements with Chile, the Andean Community and Mexico, to which countries the bulk of exports is expected to go.

G. Conclusions

During the past 15 years, the Argentinean automotive industry went through significant transformation, gradually changing its inward-oriented outlook to a more export-oriented one. The TRIMs contained in the Argentinean automotive regime, together with high levels of economic activity and the granting of preferential access under MERCOSUR, produced a favourable conjuncture which led to a dramatic increase in FDI between 1994 and 1997. The spurt resulted in retooling of and significant increase in production capacity. The industry shifted its inward-looking strategy and increasingly turned to export markets. Exports – mainly to Brazil – now constitute 56 per cent of total production.

It is against this backdrop of profound transformation that the effect of the WTO TRIMs Agreement must be analyzed. TRIMs at this stage, hand in hand with the growth of domestic demand and the opportunities brought about by the enlarged regional market, prodded the industry's upgrading. FDI inflows resulted in the opening of new plants, the modernization of the industry's productive capacity and the production of new models. These changes sought to raise the industry's standards to a more competitive level as a result of the emergence of a more sophisticated local demand, and the opportunities granted by the enlarged and protected regional market. TRIMs embodied in the automotive regime provided automobile manufacturers a set of incentives that contributed to the modernization of the industry in the midst of a favourable economic context. This policy mix included high tariff protection, which practically granted manufacturers a captive market, combined with the authorization for firms to import finished vehicles at a low tariff rate, as long as they were compensated with exports. The computation of new investments as exports for the balanced trade requirements served as well as a powerful stimulus for investments. On top of these incentives, investments were also encouraged by the booming demand, the opportunities laid by the regional market and the regional strategy pursued by car manufacturers.

In the case of the auto parts industry, the assessment is less positive. The auto parts industry was not immune to the new

conditions set by the automotive regime, the greater trade openness and the upgrading of the car industry. Suffering negative effective protection, the sector went through a profound restructuring which entailed greater internationalization and also concentration into fewer players. Small and medium-sized local firms were either driven out of business, absorbed by larger international firms, or displaced to the spare parts market. The slump which began in 1998 aggravated the process. It also led to relocation in Brazil.

The TRIMs Agreement placed a deadline for the phasing-out of balanced trade and local contents as notified by Argentina. The December 1999 WTO deadline coincided with the date established by MERCOSUR to design a common automotive policy. The recession at the time led to tough bargaining conducted with automobile firms, which had clearly over-invested during the 1990s, operating at 50 per cent of their production capacity, threatening to switch their operations to Brazil. During this period, TRIMs served to avoid a complete shake-out of the industry in the midst of a critical situation in which automobile manufacturers were scaling down their production while auto parts producers were closing down their plants in Argentina and moving their operations to Brazil. In this context, the maintenance of the local content requirement allowed by WTO until the end of 2003 served to cushion the impact of the 1998–2002 crisis on the auto parts industry. Prior to the end of convertibility in January 2002, the Argentinean content clause acted as a cap for exports and a minimum for local suppliers, at a time when the overvaluation of the peso strongly encouraged auto parts imports from Brazil. The agreement itself served as the legal umbrella to continue negotiating the Common Automotive Policy with Brazil, itself a lever of considerable value.

The agreement with Brazil was finally reached at the end of 2000. It was granted a five-year shelf life which expired in December 2005. The MERCOSUR Common Automotive Policy maintained the 35 per cent CET. In addition, the fixed share in the rules of origin allowed the maintenance of local content requirements for regional trade. Together with a balanced trade ratio, these provisions were again defensive measures designed to prevent the closing of car manufacturers and auto parts firms facing the trough in a highly unfriendly economic environment. In this vein, the adoption of a regional framework to a certain extent counterbalanced the full effect of the elimination of TRIMs mandated by WTO by the end of 2003. Policy instruments were given a safe haven within the regional agreements and they remain in place. By the time this chapter was completed, Argentina and Brazil announced an extension of the managed-trade scheme, and the draft of new regulations, effectively delaying the liberalization of automotive trade regulations within the bloc. To sum up, the effects of the removal of WTO-notified TRIMs were partially offset by regionalization under the MERCOSUR automotive policy. Intense regional negotiations have replaced multilateral ones.

The recovery of the Argentinean economy after the tailspin in 2002 led both to a recovery in the domestic demand for cars and the announcement of new investment projects by automobile manufacturers. The decision to commit further investments, though at a much lower level than the preceding decade, shows the continuing sensitivity of investment decisions to domestic demand cycles. In this regard, domestic and foreign demand cycles (especially after the industry's adoption of an export-oriented outlook) play a critical role in investment decision, even in a period of slimmer regulatory incentives than in the 1990s. The much-revamped industry now awaits the result of how the balanced trade ratio under negotiation with Brazil will be shared in the new MERCOSUR framework, while exports to other markets are on a rapid rise.

All told, coupled with high rates of effective protection, TRIMs, in their initial multilateral format, served to attract and upgrade investment; in their subsequent reduced regional reach and as the market shrank, they became more defensive, but they served to reduce the correlation between investment and the volatility of demand. Not a negligible role, given the strong effect of FDI flows on long-term growth in developing countries.

Notes

1 This chapter is based on a background paper prepared for UNCTAD by Tussie and Labaqui (2006).

2 The 1999 peak, a point in which the economy was being hit by the emerging market crisis, was due to the acquisition of the State-owned oil firm YPF by the Spanish company Repsol.

3 See WTO document G/TRIMS/N/1/ARG/1.

4 See WTO document G/TRIMS/N/1/ARG/1/ Add1.

5 Paragraph 2 of Article 5 grants developing countries a five-year term to phase out all the notified TRIMs, although according to article 5.3 a country "which demonstrates particular difficulties in implementing the provisions of this Agreement" can apply for an extension of the transition period to the Council for Trade in Goods.

6 See WTO document G/C/W/176, p. 2.

7 See WTO document G/C/W/176, p. 2.

8 See WTO document G/L/460.

9 See WTO document G/C/W/295.

10 Argentina at that time was not applying the agreed higher CET on auto parts, but applying a mere 2 per cent tariff in order to provide incentives to auto producers to assemble locally.

11 See WTO document G/L/602.

12 Quotas were calculated as a percentage of the previous year's output starting at 4.5 per cent and reaching 6 per cent by 1993.

13 The bias was probably either rooted in a "worst case scenario" for this industry or in the "lack of knowledge about the role that productive linkages play in the system's learning path" (Vispo, 1999: 302, translated from Spanish in the original).

14 The firms paid the fines but later the Menem administration pardoned them, condoned the fines and gave them back the money under the excuse that car manufacturers would channel the condoned resources to new investments (*La Nación*, 03/05/2003; Schvarzer et al., 2003).

15 Interview with Luis Katz.

16 Authors' interview with Javier Tizado, former Trade and Industry Secretary (2000–2001).

17 The expectation was that, as the automobile industry was being badly hit by local recession, lifting the cap on exports would serve to offset the decline in local demand.

18 Interview with Nicolás Cacace from the Auto-Part Producers Association (AFAC).

19 The response by vehicle producers to this context was manifold. General Motors and Citroën left the country. Volkswagen entered the market through the acquisition of Chrysler (Argentina), although it later merged its operations with Ford, creating Autolatina. Peugeot and Fiat also merged their operations and created Sevel, a firm under the economic control of a domestic group. A local firm also acquired the plants and licenses of Renault, which only regained the control of its subsidiary during the 1990s (Vispo, 1999).

20 It is worth noting that in January 1995 the bloc had established a CET and liberalized about 80 per cent of internal trade.

21 Originally, during the transition period, auto parts imported from MERCOSUR countries were counted as local production for the calculation of regional content.

22 Interview with Nicolás Cacace from the Association of Auto-Parts Manufacturers (AFAC).

23 Former Secretary of Industry Javier Tizado recalls: "We were facing quite a dramatic situation in terms of costs. We had a highly overvalued exchange rate, after Brazil undertook its devaluation... Given the level of tariff protection and the overvaluation of the peso, automobiles commanded a higher price than in Brazil. Of course, production costs were also higher… Fiscal incentives induced low-cost production in Brazil to sell in Argentina at a high price. This priced local auto part producers out of the market… and even led to the emigration of a large portion of the auto parts industry to Brazil" (personal interview).

24 Interview with Fernando Porta, Director of Centro Redes, an industry expert.

25 The automobile manufacturers' association does not report import values by firm, hence the need to resort to this proxy. For more details, see Schvarzer, et al. (2003).

26 Interview with Fernando Porta.

27 Interview with Fernando Porta.

28 Estimates put this level at 30 to 35 per cent (interview with Luis Katz), although during the 1998–2002 crisis it reached 23 per cent according to Schvarzer et al. (2003).

[29] While Daimler, Fiat and Renault expressed a preference for sticking to the 2006 schedule, Ford, General Motors and Peugeot–Citröen were not dissatisfied with the Government's initiative (*Clarin*, 17 June 2005).

III. Mexico

A. Introduction

Since the implementation of liberal economic reforms in the mid-1980s, Mexico has been one of the main recipients of foreign resources in Latin America.[1] Foreign direct investment (FDI), which was shunned in the 1970s in favour of bank loans, came to be seen in a more positive light in the 1980s because of several factors: (a) bank loans were no longer available after the beginning of the debt crisis; (b) FDI was perceived to be more stable since it was difficult to withdraw fixed capital assets; (c) FDI was recognized as a way to import technology and managerial know-how; and (d) to facilitate exports.

During 1990–1995, Mexico was the main recipient of FDI in Latin America, whereas during 1996–2000 it was second only to Brazil.[2] In addition, Mexico is the country with the greatest number of free trade agreements in the world: 12 treaties including 44 nations (including the two largest world markets: North America and Europe). The preferential access to the main markets in the world, as well as its geographic location, increases the attractiveness of the country to foreign investors.

In an attempt to increase the benefits received from FDI implemented in the past, a number of policy instruments were implemented to this end, among them a number of TRIMs. The results of their application remain a source of controversy.

This chapter examines the TRIMs used by Mexico as notified to the WTO in 1995, and assesses their impact and the impact of their elimination. It is structured as follows. Section B looks at the Mexican regulatory framework including the role of TRIMs in the formulation and implementation of industrial policies and the evolution of FDI policies. It also includes a brief review of FDI inflows. Section C describes the notifications submitted by Mexico according to article 5.1 of the TRIMs Agreement. Section D analyzes in greater detail the impact of the elimination of TRIMs. Since the notifications refer only to the automotive industry, the discussion is concentrated on this industry and considers its historical evolution, its trade and investment performance, the role of TRIMs in the industry's development, the effects of their elimination, and substitute measures implemented. The final section offers some concluding remarks.

B. The Mexican regulatory framework

In order to provide background information for the subsequent analysis of the TRIMs notifications made to WTO and the impact of their elimination, this section discusses the impacts of the use of TRIMs in the formulation of industrial policies, as well as the evolution of policies towards foreign investment in Mexico.

1. Impacts of the use of TRIMs in industrial policies in Mexico

Many Governments have imposed trade-related conditions on foreign investors in the hope that they would engage in local purchasing of inputs. Extensive use has been made of measures related to local content requirements and trade balancing tests in order to assure that the development of an industry supports the growth of a domestic supply chain and enhances the export capability. Mexico is no exception, and throughout the period in which an import substituting industrialization (ISI) strategy was followed, TRIMs were an integral part of sectoral policies.

Industrial development in Mexico after World War II (and especially during the so-called stabilizing development period) was promoted through import substitution

policies. Their main objective was to promote the expansion of the manufacturing sector, improve productivity and generate employment for the growing urban population.

Manufacturing (especially the heavy intermediates, consumer durables and capital goods sectors) benefited from three main mechanisms for the transfer of resources (Ros, 1994): (a) high prices for their products arising from protection of domestic industrial markets; (b) lower input costs resulting from energy subsidies, export taxes and licenses on some agricultural goods and minerals; and (c) low prices for imported capital goods as a result of low exchange rates and high tariff exemptions on imports of machinery and equipment which facilitated the financing of industrial investments.

During the 1960s, the ISI process began to shift from final goods to intermediate and capital goods. The Government stressed the importance of an inward economic growth through the implementation of a protectionist trade policy, quotas to imports as a stimulus to import-substitution together with high tariffs and fiscal holidays, as prescribed in the 1955 Law for the Development of New and Necessary Industries. However, as noted by Solis (2000), even though the protection provided to the industrial sector through import permits (which in 1970 affected 65 per cent of total imports) stimulated industrial activities, it had high economic costs and led to the strengthening of business groups that continuously lobbied for the indefinite maintenance of such policies. These policies contributed to the establishment of an industrial base and the modernization of the Mexican economy, but their sustainability in the long term was inevitably compromised by the limited size of the domestic market and the lack of international competitiveness.

By the end of the 1970s, distortions and limitations introduced by the ISI model (mainly the anti-export and anti-agricultural bias as well as high prices for industrial goods) began to become more evident. In 1983, all imports were subject to previous approval.[3] At that time, a new development model began to be implemented when a consensus within the Government was reached that trade restrictions were inimical to further growth. Permits were replaced by tariffs, and these were reduced gradually. Trade agreements with other nations began to be negotiated and in 1986 Mexico joined the GATT. Since then, Mexico has made the transition from a highly restrictive policy environment, in which all imports were subject to licensing requirements, to a substantially open economy.

Of the trade agreements negotiated, by far the most important was the North American Free Trade Agreement (NAFTA) with Canada and the United States. Since the great majority of Mexican trade takes place with NAFTA countries, this was tantamount to the liberalization policies being implemented. The agreement introduced changes in the regulatory environment intended to make the country more attractive to foreign and domestic private investors. The changes included the creation of a strong regime for intellectual property rights and a liberal environment towards FDI.

Another change can be observed in the use of industrial policies. Immediately after the beginning of the process of economic liberalization, policymakers did not seek to protect particular industries or firms from import competition, but rather to create a predictable environment to conduct business.[4] Until the late 1990s, two exceptions could be identified: programmes that target small and medium-sized enterprises (SMEs),[5] and the automobile industry. According to this new perspective, industrial policy should concentrate on the correction of market failures (coordination

or information problems), provision of public goods, and undertaking those projects with a high social return but not attractive to the private sector.

This liberal view of policy formulation was partially revised in the Programme for Industrial Policy and International Trade 1996–2000. In this programme, government officials implemented some incentives targeted to specific industries and aiming at increasing the domestic value added (at the industry and geographical level). The plan also advanced the idea of "efficient" import substitution, where the word "efficient" implied the achievement of this goal in the absence of subsidies or protection.[6]

For a developing country such as Mexico, the role of FDI was crucial in the process of industrial development. Nonetheless, a recurrent concern was that foreign investors created "enclaves" with few ties to the rest of the economy, leading to a "shallow" development process based on such firms. TRIMs were implemented in several industries in an attempt to avoid this situation (see the annex for the cases of the pharmaceutical and electronics industries, where domestic content and trade-balancing requirements were common).

Whether the TRIMs left some lasting effects is doubtful. At the time of their application, they encouraged the involvement of Mexican companies to comply with domestic-content requirements. Even if during this time national firms took advantage of these relationships to develop their technological capabilities, the fact that few of them today are among those with the highest sales or exports may suggest that the process of opening and economic liberalization left them relegated to a second tier or concentrated in a specific market niche. So, even if the application of TRIMs played a role in the development of these companies, it was worker training, investment in the development of technological capabilities and targeting of the right market segment that were the relevant factors that defined their current performance.

2. Policies towards foreign investment and FDI inflows

FDI provided support for ISI policies adopted in Mexico after World War II. By establishing subsidiaries in the country, TNCs provided the technological, managerial and organizational capabilities needed during industrialization. Nonetheless, the post-revolutionary Mexican State was essentially antithetical to FDI. Through the late 1930s, foreign ownership was reduced in sectors where it prevailed before the revolution: banking, railroads, electric power and petroleum (Bennett and Sharpe, 1985). Only after the technology needs of the country were realized, FDI was allowed in the manufacturing sector under the principle of Mexicanization, i.e. it would be permitted only in minority holdings.

In the early 20th century, FDI was concentrated in the exploitation of natural resources and investment in public utilities. After the interruption caused by the 1910 revolution, it began to shift to manufacturing for the internal market, taking advantage of the policies designed to encourage industrial development (tariff protection and quantitative imports controls, practically free access to the expanding infrastructure built by the State, subsidized basic inputs such as energy, etc.). FDI increased sharply from the 1950s to the 1970s, induced by economic growth, stable macroeconomic conditions and government policies that protected the domestic market, subsidized capital investments and safeguarded the purchasing power of large segments of the urban population (Calderón et al., 1996; Wionczek, 1986).

The legal aspects affecting FDI were set out in the 1973 Law to Promote the Mexican Investment and Regulate Foreign Investment. This law responded to the nationalistic concerns with regard to the growth of FDI in Mexico, the increase in acquisitions of existing Mexican firms by TNCs in the 1960s and the associated balance of payments problems (Whiting, 1992). It subjected foreign investors to registration requirements in all cases and to negotiating performance requirements for cases of majority ownership.

Even though FDI was allowed to play a role in the ISI model, a strong nationalistic view prevailed until the mid-1980s. The coincidence of the breakdown of the ISI strategy, the domestic impact of the debt crisis and other severe external shocks provoked an extensive rethinking of the Mexican development strategy and the official view towards FDI. The macroeconomic and institutional aspects of the economic and trade opening could not be completed without the recognition that internal savings in Mexico were low (Solis, 2000). Thus, the inflow of productive resources through foreign investment had to be promoted. Since then, as part of the package of economic reforms, relevant laws and regulations were modified to encourage FDI inflows within the constitutional limits imposed on foreign ownership and control of certain national assets.

The 1973 law was modified several times during the 1980s. In 1984, the National Foreign Investment Commission established that (a) previous authorization was no longer necessary when foreign capital would represent less than 49 per cent of the capital in the enterprise in question, with the exception of restricted sectors; and (b) foreign investment would be allowed – even encouraged – with participation higher than 50 per cent of the total capital in enterprises with important technological, export, employment generation and import-substitution capabilities (Dussel, 2000).

In 1993, the Mexican Congress passed the new Law of Foreign Investment, which substantially reduced administrative procedures and sought to offer legal certainty and transparency. It also established that FDI could take place in any proportion in activities not included in restricted sectors (petroleum, basic petrochemicals, electricity, nuclear energy generation, radioactive minerals, certain transport services and a range of other service activities). Restrictions took the form of outright prohibition or ceilings on equity participation. A notable feature of this regime was the absence of incentives (e.g. fiscal) to attract foreign investors and to locate in a given region (in contrast to the 1973 law that encouraged FDI to establish outside the industrial areas of Mexico City, Monterrey and Guadalajara).

Of relevance for manufacturing was the elimination of restrictions of majority foreign ownership in secondary petrochemicals, the auto parts industry, and the manufacture of buses and trucks. With the exception of basic petrochemicals and the manufacture of armament and explosives, the manufacturing sector was left almost completely open to FDI (Moreno-Brid, 1999). According to article 29 of the law, the National Foreign Investment Commission should evaluate the requests of foreign investors according to four criteria: (a) the impact of the project on employment and labour training; (b) the contribution to the development of technological capabilities; (c) respect of environmental laws and regulations; and (d) the overall contribution to increase the competitiveness of the country's productive structure.[7]

NAFTA is the first agreement of its kind to provide for international investment rules and a liberalized environment for trade in services (Moeser, 1997). It includes a

chapter on investment that lays down a framework for the treatment of foreign firms.[8] Under NAFTA, investors receive national treatment or most favoured nation (MFN) treatment, whichever is most favourable. The right of expropriation is limited only to actions that have an explicit public purpose, followed by just and prompt compensation. Also, existing performance requirements are eliminated, and new performance requirements prohibited.[9] Sectors exempted from these rules include Mexico's energy and rail industries,[10] United States airlines and radio communications, and Canada's cultural industries.

The 1996 Reform to the 1993 Law of Foreign Investment, as well as the rules of implementation approved in 1998, assured the compatibility of the Mexican regulatory framework and NAFTA, including aspects related to intellectual property rights. The reforms implemented in 1996 allowed a greater participation of foreign capital in several activities in the financial industry (49 per cent as compared to the original ceiling of 30 per cent established in the 1993 law). Such a ceiling was again raised in 1999, allowing majority foreign ownership in many activities in the financial industry. These changes paved the way for massive acquisitions from foreign companies in the Mexican financial sector (among them, the biggest bank in Mexico).

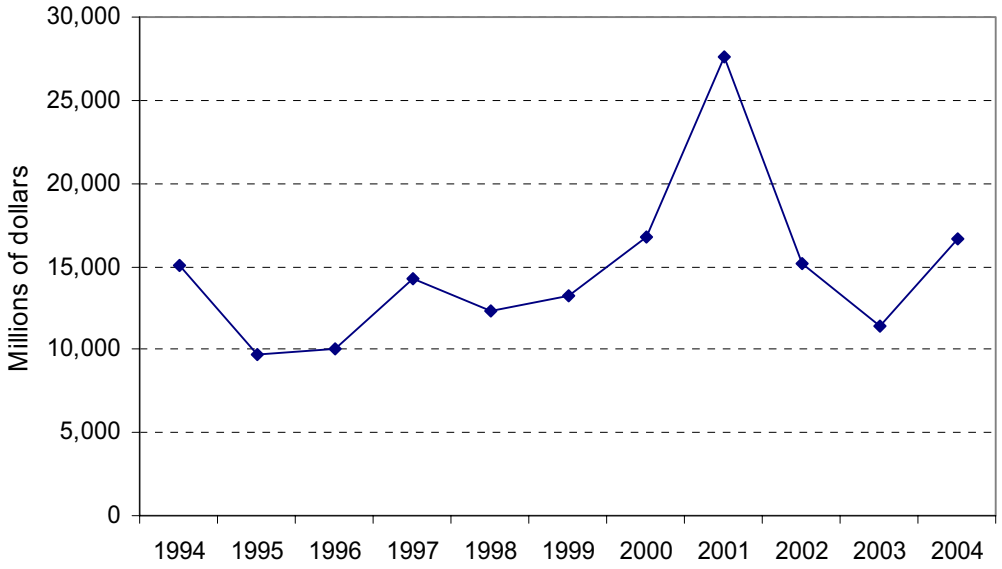
As a reflection of the new development strategy implemented since the early 1980s that placed more emphasis on international trade and FDI as sources of growth, and since the implementation of NAFTA, the Government has been one of the main promoters of the deregulation of international investment. Besides the negotiation of numerous trade agreements,[11] it has been active in the negotiation of Treaties for the Promotion and Reciprocal Protection of Investments, which have been subscribed with countries such as Spain, Switzerland and Argentina. Such treaties aim at promoting capital flows, providing legal certainty to investors of those countries, and include some provisions similar to those contained in chapter XI of NAFTA.

The impacts of changes in policies can be seen in the FDI flows to Mexico, which have increased dramatically since the beginning of the 1980s. During the period 1980–1985, when the economy was still closed, the average inflow was $1.3 billion. Once the country was admitted to GATT, this average increased to $3.5 billion during 1986–1993. In 1994, inflows reached $15 billion following the enactment of the new Law of Foreign Investment in 1993 and NAFTA entering into force.

Figure III.1 shows the annual flows of FDI to Mexico for the period 1994–2004.[12] They declined in 1995–1996 as a consequence of the financial crisis that momentarily reduced the attractiveness of the country. After recovering in 1997, they began to decline again in 1998–1999, partially as a result of the increased attractiveness of other emerging markets (most notably Brazil). The steep rise in 2001 can be attributed to a single operation worth $12.5 billion, the acquisition of Banamex (the main commercial bank in Mexico) by Citigroup. This transaction was possible thanks to the reforms made to the law regarding the foreign participation in the financial sector, as described above.

TNCs have followed two main strategies when investing in Mexico: *efficiency-seeking* (especially in the automobile, auto parts, apparel and electronics sectors) producing mostly for export; and *market-seeking* (steel, food and beverages, pharmaceutical, wood and paper, tobacco, petrochemical and financial services) producing predominantly to supply the domestic market. This should be contrasted with the *natural-resources-seeking* investments of the early decades of the 20th century.[13]

Figure III.1. Inflows of FDI to Mexico, 1994–2004

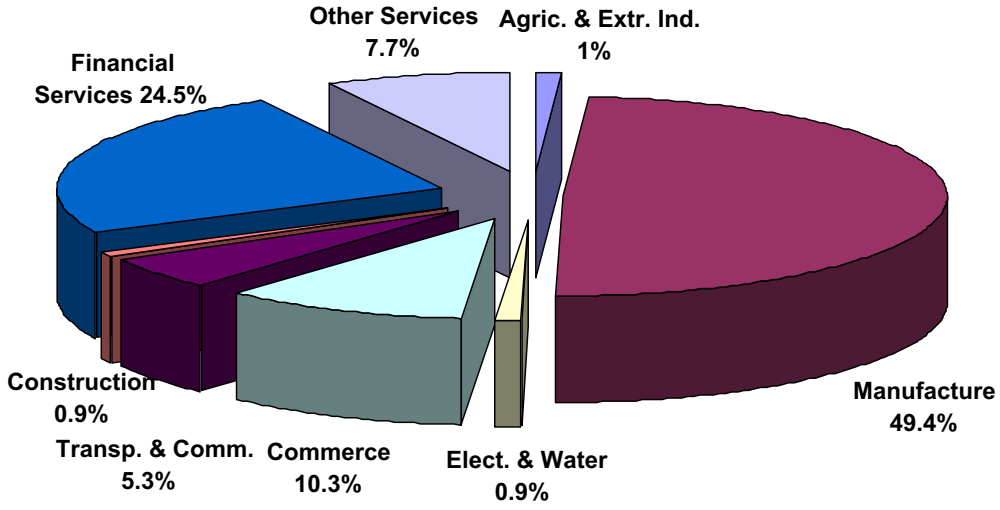


Source: Ministry of Economy.

The sectoral distribution of the stock of FDI is displayed in figure III.2 for the period 1994–2004. This figure reveals the historical preference of foreign investors for the manufacturing sector (which accounts for almost half of the total stock), although its share has been declining in favour of investment in the service sector.

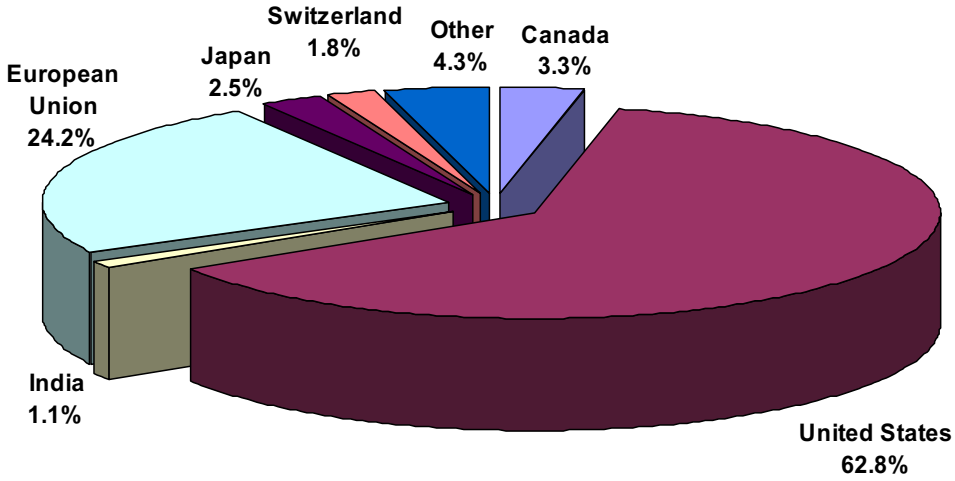
Figure III.3 shows the country of origin of the FDI stock for the period 1994–2004. By far the greatest contributor is the United States, accounting for 63 per cent of the total stock. The European Union is the second most important investor in Mexico, with 24 per cent of the stock. Within the European Union, the top sources are Spain (8.5 per cent), the Netherlands (7.8 per cent), the United Kingdom (3.6 per cent) and Germany (2.6 per cent).

Figure III.2. Sectoral distribution of FDI, 1994–2004



Source: Ministry of Economy.

Figure III.3. Country of origin of FDI, 1994–2004



Source: Ministry of Economy.

C. TRIMs notifications made by Mexico

Mexico submitted only one TRIMs notification, pertaining to the automotive and auto-transportation vehicles industries.[14] After TRIMs were applied to several industries in Mexico as part of industrial polices, by 1995 only those being applied to the automotive industry had survived.

As originally scheduled, TRIMs would have to be eliminated by 1 January 2000 (considering a transition period of five years for developing countries, including Mexico). However, Mexico requested an extension under article 5.3 of the agreement. The country submitted a request in December 1999 for a four-year extension to the transition period, i.e. to 31 December 2003. This would parallel the agreement reached in NAFTA.

Countries requesting extensions accepted the proposal "two by two" made by the chair of the Council for Trade in Goods in November 2000. This involved automatic two-year extensions until the end of 2001, with requests for additional extensions for a maximum period of two years to be submitted by 31 August 2001. These extensions would be considered along with a phase-out plan for the remaining TRIMs. Granting Mexico the extension requested was acceptable to the United States because such an extension would serve to align Mexico's NAFTA and WTO commitments.

The terms of the notification are detailed in table III.1 for the automotive industry and in table III.2 for auto-transportation vehicles. The tables contain the official answers (as reported in the legal document) to 10 fundamental questions regarding the nature of the TRIMs, including the category in the illustrative list under which the measure falls, date of implementation, provisions for their elimination, and level of Government applying the TRIM. Due to the sometimes cryptic language used in the notification (where the actual nature of the TRIMs being applied is not even specified), after each table more details are provided regarding the nature of the TRIMs being reported.

The purpose of this section is to describe the content of the notification submitted by Mexico. The effects of the measures applied on the targeted industries (for the Mexican case, only on the automotive industry), as well as the trade flows affected is described in the subsequent section.

Table III.1. TRIMs notification in the automotive industry

1. Category in the illustrative list under which the measure falls
It is uncertain whether the various provisions of the Decree for the Development and Modernization of the Automotive Industry (hereinafter called the "Auto Decree") fall within one or various categories of the illustrative list, or are not covered by any of them. This is a question of interpretation that is not within the competence of any member of WTO.
2. Whether the TRIM is applied by the Government under discretionary authority or mandatory legislation
The Auto Decree is applied as mandatory legislation.
3. Whether the TRIM is general in nature
The Auto Decree is general in nature since it applies to the automotive industry. In accordance with the decree, the industry is understood as consisting of all enterprises which make up the vehicle assembly and auto parts industries (both the vehicle assembly and the auto parts industries are defined in detail in article 2.IV and 2.V of the decree).
4. Whether the mandatory legislation requires the TRIM to be applied to new enterprises or new investments of existing enterprises
The Auto Decree applies to the automotive industry, without specifying whether it concerns new enterprises or new investments.
5. Whether compliance with the measure by the enterprise is (a) mandatory or enforceable under domestic law or administrative rulings or (b) necessary to obtain an advantage
The Auto Decree contains two types of provisions. Under the second of these, the advantage consists of being able to supplement the enterprise's supply of vehicles on the national market by importing new vehicles.
6. Whether the TRIM relates to specific products
The Auto Decree does not refer to specific products.
7. The date of implementation of the TRIM
The Auto Decree came into force on 15 June 1990.
8. Whether the TRIM includes provision for its phasing-down and/or elimination
The Auto Decree does not include provision for its phasing-down and/or elimination. The adjustments provided for in article 12.I and 12.II have already been effected. They refer to the use of surpluses in the trade balance of an enterprise in the vehicle assembly industry to import vehicles. In 1991, for each peso of imports, 2.5 pesos would be subtracted from the outstanding balance; this figure was reduced to 2.0 during 1992 and 1993, and to 1.75 in 1994. In addition, the number of vehicles imported by each enterprise during 1991 and 1992 could not exceed 15 per cent of the total number of vehicles sold by a particular enterprise in Mexico. This percentage was increased to 20 per cent in 1993.
9. Domestic law, regulation or administrative guideline under which the TRIM is applied
• Decree for the Development and Modernization of the Automotive Industry, published in the Official Journal of the Federation on 11 December 1989; • Decree reforming and supplementing the Auto Decree, published in the Official Journal of the Federation on 8 June 1990; and • Resolution that Establishes Rules for the Implementation of the Auto Decree, published in the Official Journal of the Federation on 30 November 1990. It is noted that, within the context of NAFTA, it was agreed that Mexico could maintain until 1 January 2004 the provisions of the Auto Decree and its Implementing Regulations, even though they are inconsistent with the above agreement, in accordance with the conditions set out in it. It was also set out in NAFTA that requirements relating to national added value and trade balance would be gradually reduced in accordance with the provisions of paragraphs 6, 8 and 12 of appendix 300-A.2. NAFTA has been part of Mexican legislation since 1 January 1994.
10. The level of Government applying the TRIM
Federal. The Ministry of Trade and Industrial Development[15] and the Inter-ministerial Automotive Industry Commission.

The main piece of legislation that established TRIMs was the Decree for the Development and Modernization of the Automotive Industry (the Auto Decree). It was enacted during the administration of Carlos Salinas de Gortari and had as its main objective to consolidate the advances achieved in the automotive industry and to increase its participation in international markets. The automotive industry comprises the vehicle assembly and auto parts industries. As detailed below, the TRIMs included were *local content* and *trade-balancing requirements*.

Article 5 of the Auto Decree established that the enterprises in the vehicle assembly industry could not sustain deficits in their respective trade balances. There was a provision that balances could be transferred between enterprises. In addition, from 1992, the trade balance of an enterprise could be increased by the accumulation of surpluses from past years (article 10). Finally, those enterprises that invested to increase their productive capacity using fixed assets of national origin would be able to add up to 30 per cent of such investments in the calculation of their respective trade balances (article 11). The value of total imports that a given enterprise could realize was detailed in the resolution that establishes the rules of implementation of the Auto Decree and took into account the trade balance of that enterprise, the transfer of balances from other enterprises with surpluses, and the amount of investment on fixed assets of national origin, among other variables.

The decree also contained local content requirements. With the purpose of encouraging the use of parts and components produced by domestic suppliers and the auto parts industry, the national added value of these parts and components incorporated in the vehicle assembly industry were to be not less than 36 per cent (article 7).

In addition to the Auto Decree, the other relevant piece of legislation was appendix 300-A.2 of NAFTA. It established that Mexico could maintain until 1 January 2004 the provisions of the Auto Decree. Once NAFTA came into effect in 1994, the local content requirement of 36 per cent established in the Auto Decree was reduced to 34 per cent. This percentage remained unchanged for a five-year period with an annual reduction of 1 per cent afterwards to reach 29 per cent in 2003. The requirement was eliminated in 2004.

Trade-balancing requirements were also gradually reduced by virtue of the treaty until its complete elimination in 2004. In addition, article 17 eliminated any restriction that limited the number of vehicles that an enterprise could import to Mexico in relation to the total number of vehicles that the enterprise sells in the domestic market (as article 12 of the Auto Decree established).

Regarding the auto-transportation vehicles industry, NAFTA allowed Mexico to adopt or maintain restrictions on the imports of auto-transportation vehicles from any of the parties, according to Article 21. Nonetheless, these measures were eliminated on 31 December 1998.

Table III.2. TRIMs notification in the auto-transportation vehicles industry

1. Category in the illustrative list under which the measure falls
It is uncertain whether the provisions annexed to the decree promulgating NAFTA (hereinafter called the "decree issuing provisions governing auto-transportation vehicles") fall within one or various categories of the illustrative list, or are not covered by any of them. This is a question of interpretation that is not within the competence of any member of WTO.
2. Whether the TRIM is applied by the Government under discretionary authority or mandatory legislation
The decree issuing provisions governing auto-transportation vehicles is applied as mandatory legislation.
3. Whether the TRIM is general in nature
The decree issuing provisions governing auto-transportation vehicles is general in nature since it applies to manufacturers of auto-transportation vehicles. In accordance with the decree issuing provisions governing auto-transportation vehicles, a "manufacturer of auto-transportation vehicles" means an enterprise constituted or organized under the law of, and operating in, Mexico: (a) that is registered with the Ministry of Trade and Industrial Development (SECOFI); (b) that manufactures auto-transportation vehicles in Mexico; and (c) where the enterprise's: (i) total invoice value of sales of auto-transportation vehicles and auto-transportation parts that it produces in Mexico; minus (ii) total invoice value of sales of auto-transportation parts that the enterprise imports directly, plus the value of the import content of auto-transportation parts that it purchases in Mexico, is equal to at least 40 per cent of its total invoice value of sales of auto-transportation vehicles and auto-transportation parts that it produces in Mexico.
4. Whether the mandatory legislation requires the TRIM to be applied to new enterprises or new investments of existing enterprises
The decree issuing provisions governing auto-transportation vehicles applies to all manufacturers of auto-transportation vehicles, without specifying whether it concerns new enterprises or new investments.
5. Whether compliance with the measure by the enterprise is (a) mandatory or enforceable under domestic law or administrative rulings or (b) necessary to obtain an advantage
The decree issuing provisions governing auto-transportation vehicles contains two types of provisions. Under the second type, the advantage consists of being able to supplement an enterprise's supply of auto-transportation vehicles on the national market by importing such vehicles.
6. Whether the TRIM relates to specific products
The decree issuing provisions governing auto-transportation vehicles does not refer to specific products.
7. The date of implementation of the TRIM
The decree issuing provisions governing auto-transportation vehicles came into force on 1 January 1994.
8. Whether the TRIM includes provision for its phasing-down and/or elimination
The measures contained in the decree issuing provisions governing auto-transportation vehicles will not apply after 31 December 1998.
9. Domestic law, regulation or administrative guideline under which the TRIM is applied
Appendix 300-A.2 of the decree promulgating NAFTA, published in the Official Journal of the Federation on 20 December 1993.
10. The level of Government applying the TRIM
Federal: the Ministry of Trade and Industrial Development.

D. TRIMs impact assessment: the case of the automotive industry

The effectiveness of the policies implemented regarding FDI can be assessed at two levels (OECD, 2002):

- Do they encourage or discourage the flows of FDI?
- Do they achieve the development objectives for which they were initially intended?

Also, as expected, government policy and its effects are highly industry-specific. Among the options traditionally available to government policymakers (at least until the process of economic liberalization began) were the enactment of performance requirements towards TNCs (generally through sectoral programmes), the level of enforcement of industrial property rights and the regulation of technology transactions, among others. For the case of the automotive industry, the main objective of implementing TRIMs was to increase the degree of national integration in the production of vehicles and auto parts while maintaining a positive trade balance.

This section discusses the impacts of the elimination of TRIMs for the only industry included in the notifications submitted to the WTO by Mexico: the automotive industry. It starts with a historical perspective of its development, as well as a brief review of its trade performance and the role of FDI. It then turns to the impacts of the TRIMs and of their elimination. The section ends with a discussion on substitute measures applied.

1. Historical perspective

The manufacture of automobiles requires steel, aluminum, glass, fibre, electronic components and other technologically advanced supplies. The high number of components, large volume of production required, and stringent quality standards make the automobile industry attractive for the advancement of the process of industrial development. The Government of Mexico recognized the potential benefits that could be generated from this industry and implemented a number of policy measures to foster its development.

Several stages can be identified in the development of the Mexican automotive industry. The first took place between 1925 and 1962 (Peres, Nuñez, 1990). It was characterized by the shaping of an assembly-type industry using imported assembly kits. The strategy followed by foreign investors was market-seeking, in anticipation of the domestic market growth. Under this strategy, the use of domestic parts was small, reaching a maximum of 20 per cent.

The second stage comprised the period 1962–1977, and it saw the origins of an active industrial policy. The assembly industry was then transformed into a manufacturing one. The industry seemed like an ideal candidate to deepen the ISI process, and in 1960 an inter-ministerial committee headed by the main development bank (NAFIN) presented a set of proposals to articulate a policy for the auto industry, including local content requirements. The 1962 Automotive Decree included measures aiming at increasing the degree of Mexican value added in the manufacture of motor vehicles to 60 per cent.

Foreign TNCs agreed to undertake local production. This decision has been explained by the "follow-the-leader" behaviour of automotive firms (Whiting, 1992). Since Ford moved early to comply with the requirement in a bid to capture the market, other firms had to follow suit in order to defend their competitive positions. However, the 1962 decree did not improve the balance of payments for the auto industry. A plan was therefore formulated in 1969 to promote exports by requiring that firms increasingly compensate with exports

for the imported content of the vehicles manufactured. A 1972 decree mandated that, by 1974, vehicle manufacturers should use 40 per cent of their foreign exchange earnings to buy auto parts and other goods and services from Mexican suppliers. Exports grew from $26 million in 1970 to $122 million in 1975, but the auto trade deficit surged to $1 billion (Moran, 1999).

At the beginning of the 1970s, the automotive industry was the largest manufacturing activity, accounting for 5.3 per cent of the value of production and more than 60,000 jobs (Peres Nuñez, 1990). However, even though the goal of national integration was achieved, the industry suffered from persistent trade deficits due to the almost exclusive orientation towards the domestic market and plants with small production scales that limited their performance.

The third stage of the industry's development took place between 1977 and 1982, and was characterized initially by the persistent trade deficit and the foreign-exchange crisis of 1976. At that time, Mexican authorities were frustrated by the reluctance of auto companies to increase the level of sourcing for the United States market. A new policy set out in the 1977 decree raised the requirements for integration of national parts, established foreign exchange budgets for each producer, and eliminated production quotas and price controls in order to encourage productivity gains. In effect, the decree made access to the Mexican market contingent upon export expansion. To such an end, a trade-balancing TRIM was established requiring that imports be matched with exports.

Beginning in 1979, foreign enterprises began to set up plants producing mainly for export, in response to the export promotion policy and also in accordance with their strategies involving a major international transformation. After the initial resistance to the Government's push for exports from the part of American automotive firms, General Motors (whose managers realized the need for extreme cost-cutting efforts in order to remain competitive in the face of Japanese competition) broke ranks with the rest of the companies and announced new investments in Mexico. Within months, Ford, Chrysler and Volkswagen followed suit. The presence of these companies stimulated complementary investments by foreign firms producing auto parts. The creation of backward linkages was extensive, since within five years there were 310 domestic producers of parts and accessories (110 of which had annual sales of more than $1 million) (Moran, 1999). These suppliers were introduced to the industry's best practices as part of the training provided by the foreign companies.

The competitive advantage obtained by Japanese automotive firms by the implementation of new production systems (e.g. "lean manufacturing" implemented by Toyota) allowed them to make inroads into the OECD market, especially the American one. This is clearly seen in table III.3, where a fall in the participation of exports from the United States is also evident. The results of the strategy implemented by American firms consisting in moving export operations to developing countries (including Mexico) are reflected in the increasing share of automotive goods produced in Mexico.

Table III.3. OECD market shares in traded automotive goods, 1963–1995 (%)

Country	1963	1971	1980	1990	1995
Japan	0.6	7.8	19.3	21.9	18.6
United States	21.4	19.0	14.9	10.0	10.9
Mexico	0.0	0.2	0.4	2.3	3.6

Source: Mortimore (1998).

During the period 1977–1981, the industry increased its average yearly output by 18.8 per cent and its employment by 13.8 per cent. However, it was severely

affected by the 1982 debt crisis, when its output dropped by more than 20 per cent (Peres Nuñez, 1990). By 1981, the industry accounted for more than half of the commercial trade deficit (Whiting, 1992).

A fourth stage of development began in 1983 with a new decree. The new policy tried to solve several of the problems affecting the industry: insufficient incorporation of national parts, non-competitive prices, and excessive number of lines and models, among others. In September 1983, the Decree for the Rationalization of the Automobile Industry was promulgated in response to the balance-of-payments deficit and the urgent need for foreign exchange. The decree increased local content requirements from the 50 per cent set in the 1977 decree to 55 per cent for 1986 and 60 per cent in 1987. In addition, firms were still required to compensate imports with exports. To encourage the increase in exports and local content levels, the decree also reduced the number of makes and models. It was hoped that this rationalization would lead to higher local content.

The export requirements contained in the 1977 decree as well as the provisions of the 1983 decree were successful in persuading the international auto firms to give Mexico an important place in the global production schemes of the main auto companies (Whiting, 1992). The 1989 Auto Decree (described in section C) had three key provisions: import restrictions, trade-balance requirements and local content requirements.

A new stage in the development of the automotive industry began with the negotiation of NAFTA. NAFTA facilitated the integration of the automobile industry in North America by allowing significant reductions in tariffs and non-tariff barriers. At the time the agreement went into effect, Mexico lowered its tariff on autos from 20 per cent to 10 per cent, and this tariff level was to be phased out over time.

As part of the Mexican compromises under NAFTA, the local content requirement level was reduced to 34 per cent. This percentage was set to remain unchanged for a five-year period with an annual reduction of 1 per cent afterwards to reach 29 per cent on 2003 and to be eliminated the year after. Thus, since 2004, only the regional content has to be followed. The rules of origin established under NAFTA aim at promoting further integration between the three countries' industries. It was established that, for vehicles, engines and transmissions, rules of origin were such that 50 per cent of the net cost of production should come from North American-made inputs during the first four years, then increased to 56 per cent and finally set at 62.5 per cent. Also, in January 1994, trade balancing requirements were reduced to $.80 of exports for every dollar imported. These would be brought down to $.55 by 2003 and eliminated in 2004. On 1 January 2004, all the dispositions contained in the 1989 decree had to be made compatible with NAFTA, which implicitly implied its elimination.

One of the main impacts of NAFTA was to convince international investors of the decision of the United States Government to incorporate the Mexican economy as an export platform to the American market, as long as the manufactured goods had a minimum level of regional content. In the automotive industry, this had as a consequence that companies from outside the NAFTA region would have to develop a network of local suppliers in order to comply with the regional content.

About a decade after the implementation of NAFTA, the Mexican automotive industry is more integrated and has higher levels of competitiveness in international markets, as shown by the

indicators presented in table III.4 for the final assembly sector.

Table III.4. Comparative statistics for the Mexican auto industry (final assembly), 1994 and 2002

	1994	2002
Production (millions of units)	1.1	1.77
Exports (millions of units)	0.57	1.31
Internal Market (millions of units)	0.59	0.98
Domestic Value Added (%)	41	51
Trade Balance (millions of dollars)	4 471	13 297

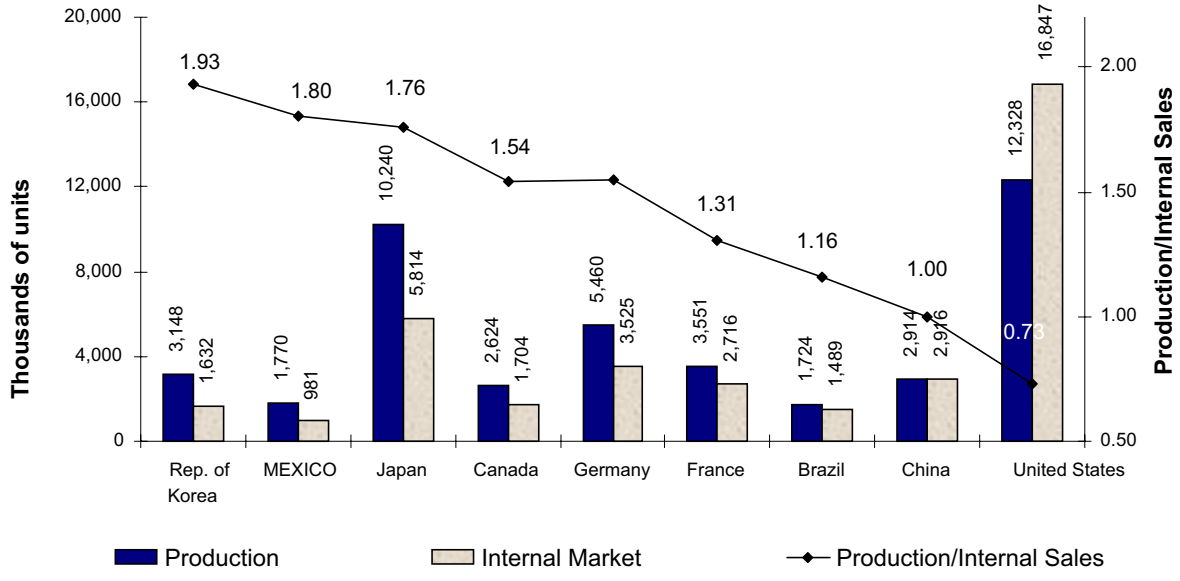
Source: Ministry of Economy, INEGI.

However, during the past decade, the gap in performance between the final assembly and the auto parts sectors has been growing. During 1990–2000, labour productivity and value added increased more in the final assembly sector (Mortimore and Barron, 2004), whose competitive position improved above that experienced by the auto parts segment of the industry. This was due in part to the fact that the base of suppliers located in Mexico specialized in labour-intensive activities, playing only a complementary role based on cost-reducing strategies, while the suppliers located in the United States retained a decisive role in assembly operations in Mexico (Mortimore and Barron, 2004).

2. Trade implications

Since the beginning of the process of economic liberalization that culminated with the implementation of NAFTA, the automotive industry has been one of the engines behind the export dynamism experienced by Mexican manufactures. Whereas in 1994, of the 1,096,791 units produced, 53 per cent were destined for export; in 2002, 74 per cent of the total production of 1,774,369 units was exported. Figure III.4 presents an international comparison of production and internal sales in the automotive sector for 2002. As can be seen, of the countries included, only the Republic of Korea has a higher ratio of production/internal sales, which reveals the definitive export orientation of the industry in Mexico.

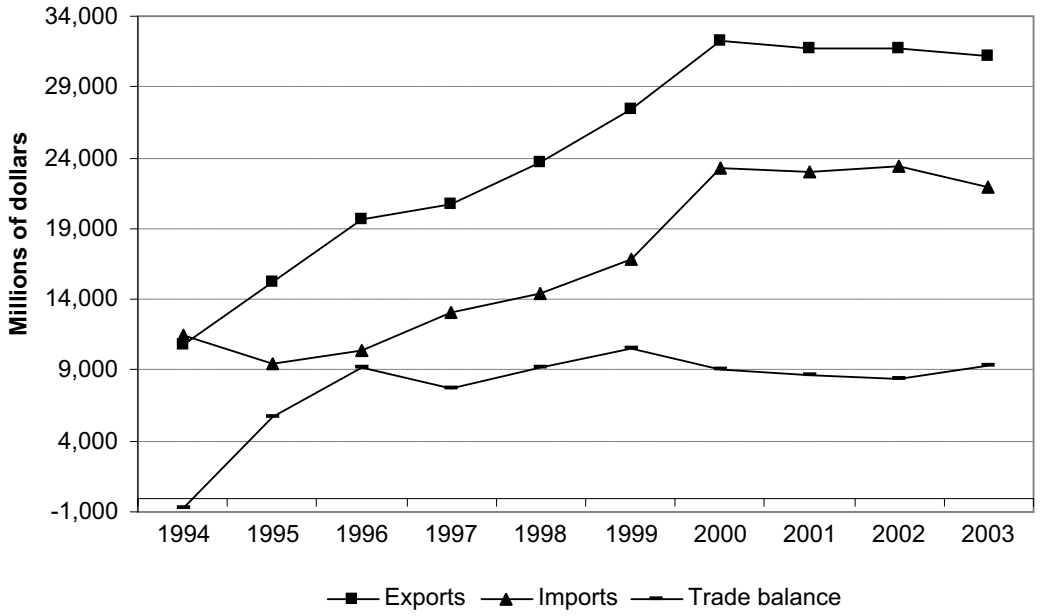
Figure III.4. International comparisons of production and internal sales in the automotive sector, 2002



Source: Ministry of Economy of Mexico.

The trade balance of the automotive industry has been positive since 1995 (figure III.5). During 1994–2003, exports increased 189 per cent whereas imports increased by 91 per cent. This explains the persistent trade surpluses for the industry. From 2000, the value of the surplus has remained more or less constant at $9 billion.

Figure III.5. Trade balance for the automotive industry, 1994–2003



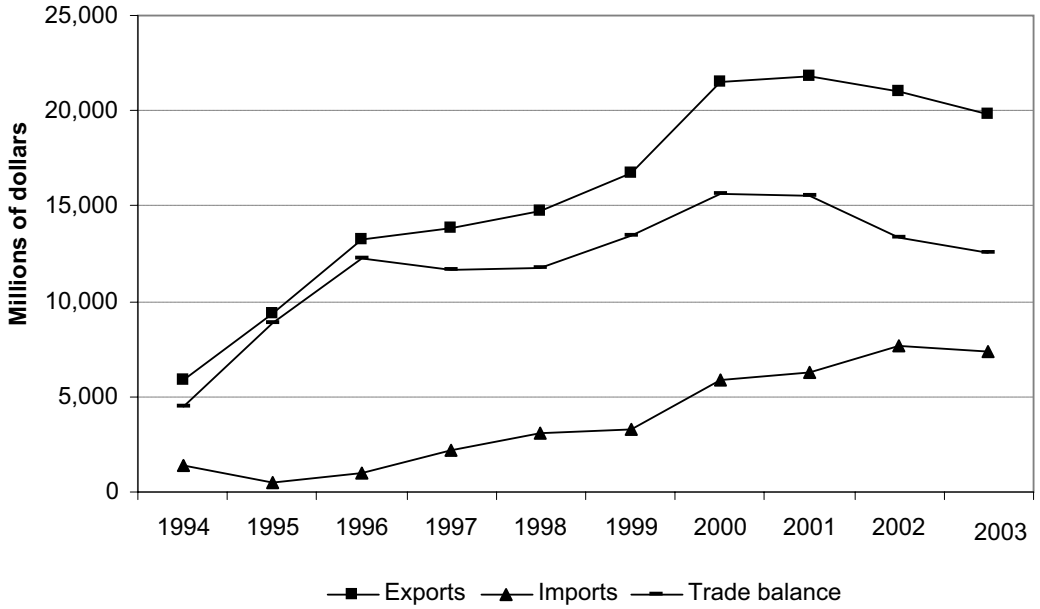
Source: INEGI, *La Industria Automotriz*, several years.

There are, however, significant differences in the trade performance of the final assembly and auto parts sectors. The trade balance for both industry segments is shown in figures III.6 and III.7 respectively.

The final assembly sector showed a positive trade balance for the entire period. Even though the growth of exports was more or less constant, the growth of the trade surplus was not as spectacular, due to the increase in imports since 2000. Still, by 2003, the value of exports of vehicles was 2.7 times that of imports. The main markets for exports are Canada and the United States, Mexico's NAFTA partners. In 2003, 10.6 per cent of the total of units exported went to Canada, and 84 per cent were destined to the United States market.

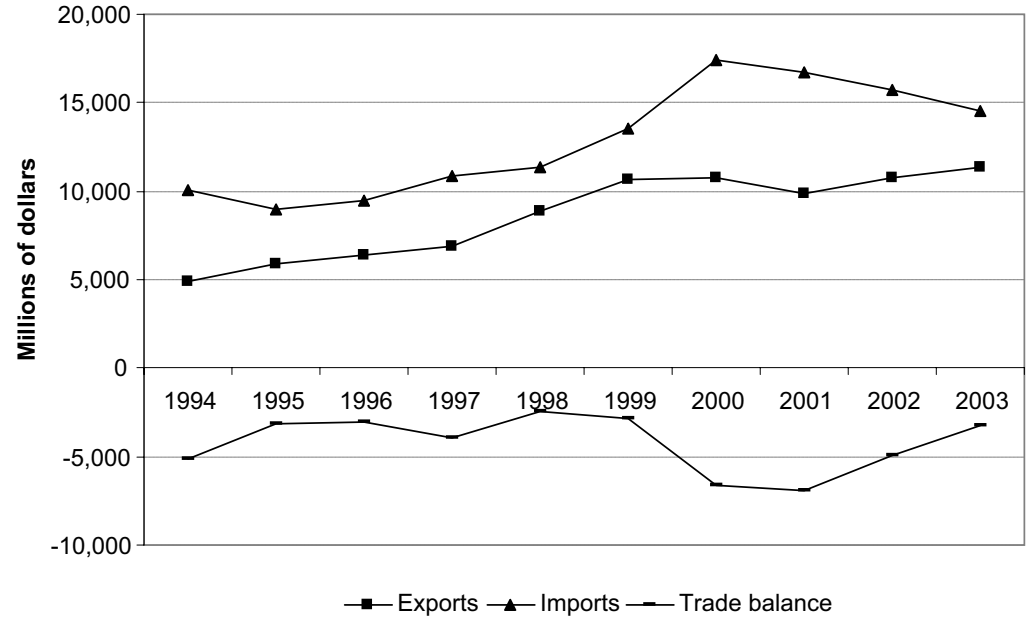
The case of the auto parts segment cannot be more of a contrast, since it experienced trade deficits for the entire period. Exports showed a constant growth (with only a slight decline in 2001), but the amount and rate of increase were not enough to eliminate the persistent trade deficit. The decrease in imports experienced since 2000 has contributed to the reduction of the trade deficit. This fall in imports is mirrored by the decrease in exports of finished vehicles. The continued reliance on imports to source auto parts is an indicator of the existing opportunities to develop domestically-based suppliers, but at the same time it is an expression of the difficulty experienced by them to meet the quality, prices and time delivery requirements demanded by final assemblers and suppliers in the first tier.

Figure III.6. Trade balance for the final assembly segment, 1994–2003



Source: INEGI, *La Industria Automotriz*, several years.

Figure III.7. Trade balance for the auto parts segment, 1994–2003

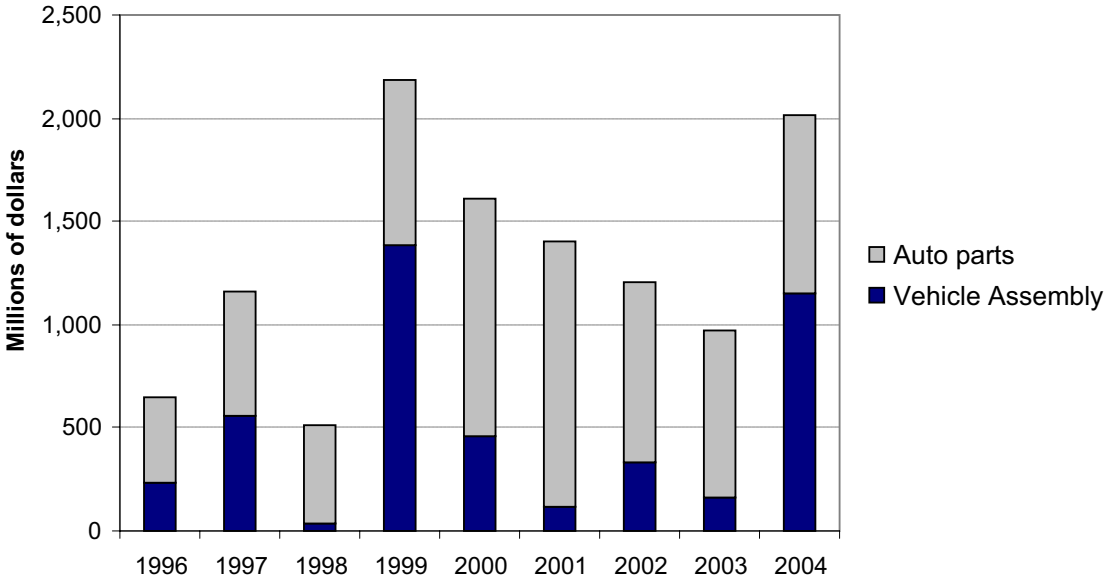


Source: INEGI, *La Industria Automotriz*, several years.

3. Foreign investment implications

The increased importance of Mexico as an export platform to the North American market has been reflected in the continuous flow of FDI. As shown in figure III.8, nonetheless, the flow during 1996–2004 has been somewhat erratic.

Figure III.8. FDI inflows in the Mexican automotive sector, 1996–2004



Source: Ministry of Economy. The category "Vehicle Assembly" includes class 384110 of the Mexican Classification of Activities and Products; the category "Auto parts" includes classes 384121, 384122, 384123, 384124, 384125 and 384126.

The behaviour of FDI inflows is not surprising, considering the variety of factors that come into play in the decision to invest in a country: the situation of the American market, the production capacity in other countries, the relative attractiveness of other countries and the investment plans of individual firms, to name just a few.

After a sudden increase in 1999, FDI inflows steadily decreased until 2003. However, FDI in 2004 in the auto industry more than doubled from 2003, to reach the highest level since 1999 (coincidentally, 2004 was the first year without TRIMs in the Mexican regulation). According to industry analysts, the enterprises investing the most are those with existing operating plants in the country (Ford, Nissan, Volkswagen and Chrysler, among others) that are introducing new models. This surge in investment shows that Mexico is still an attractive location for the international automotive industry, mainly due to its cheap and skilled labour, a favourable regulatory framework and its geographic proximity to the American market (*Reforma,* 2005).

Cumulative flows of FDI for 1999–2004 in the sector ($9.4 billion, which accounts for 21.2 per cent of total FDI inflows in the manufacturing sector during the same period) reveal that the United States was the main investor, with 57.6 per cent of the total, followed by Japan (18 per cent), Canada (8.9 per cent) and Germany (6.6 per cent). Thus, the American dominance in the Mexican automotive industry is clear.

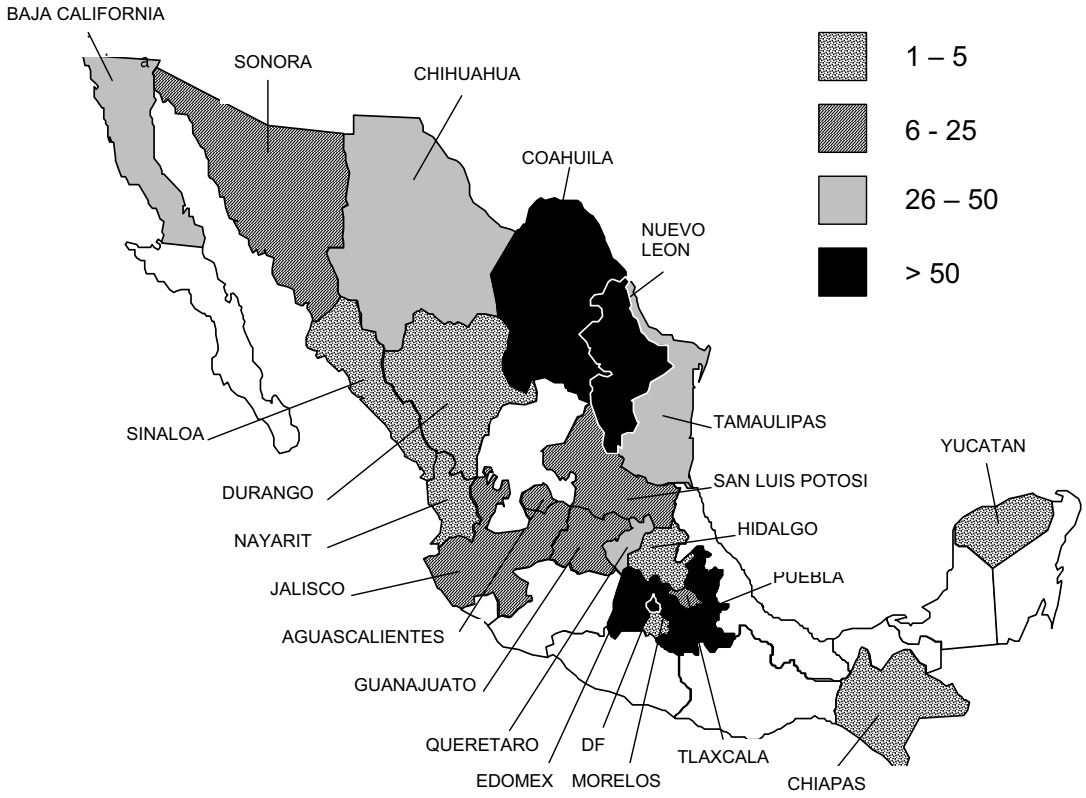
By December 2004, there were 609 enterprises with FDI in the Mexican automotive industry, representing 2 per cent of the total of enterprises with foreign capital established in the country (30,939). About 64.5 per cent of these enterprises were owned from the United States, 11.3 per cent from Germany, and 5.7 per cent from Canada.

The main foreign firms in the industry are also positioned among the most important in the Mexican economy (in terms of sales). According to the 2005 ranking prepared by the business magazine

Expansión, the five most important firms in the automotive sector are General Motors (ranked No. 6), Daimler Chrysler (No. 7), Nissan (No. 14), Volkswagen (No. 15) and Ford (No. 24). With the exception of Delphi Automotive Systems (No. 10), auto parts firms rank lower in importance.

The geographical distribution of the enterprises with foreign participation is shown in figure III.9, which indicates the number of enterprises in each State. It should be noted that 60 per cent of the total number of firms in the sector are located in just 5 States (marked in black: Distrito Federal, Estado de Mexico, Coahuila, Puebla and Nuevo Leon). From the figure, we can observe that the States which host the greatest number of enterprises in the sector are located in the central and north-east regions of the country. Important manufacturing facilities, however, are located in States not included in the group (for example, Sonora or Baja California). In terms of the total FDI flow received during 1999–2004, the central region received more than half of the total (Distrito Federal with 45.5 per cent and Puebla with 10.5 per cent of the total).

Figure III.9. Geographical distribution of the 609 enterprises with foreign participation in the automotive sector, 2004



Source: Author's elaboration based on data from the Ministry of Economy.

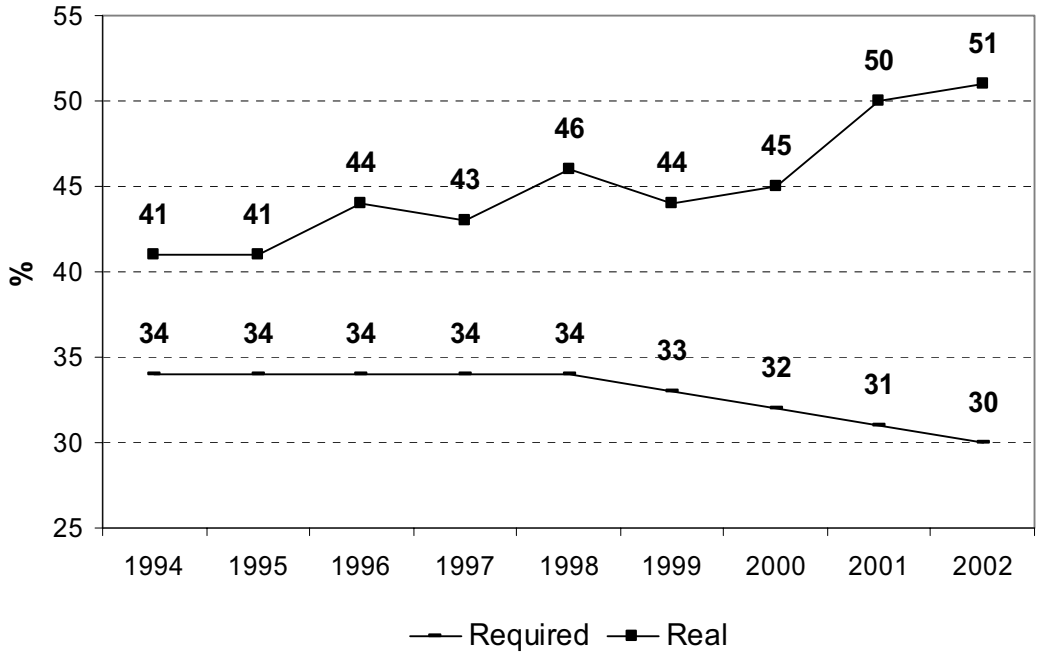
4. TRIMs and their elimination

The time since the elimination of TRIMs has been relative short. Therefore, an impact assessment is preliminary. How much did TRIMs implementation advance the objectives for which they were established? As noted, domestic content requirements and trade balancing were established in an attempt to increase the degree of national integration of the industry without putting pressure on the balance of payments through excessive trade deficits.

One reason for the perceived negative impact of domestic content requirements is that they may make it more difficult for firms to capture full economies of scale to become internationally competitive. During the 1960s and early 1970s, Mexico set domestic content requirements at 60 per cent. However, many of the auto parts manufactured in the country turned out not to be competitive in price and quality (de María y Campo, 1991). On the other hand, as Moran (1999) notes, as the size of the domestic market grew to support plants with full economies of scale, the cost and quality of manufacturing a range of components began to rival imported alternatives. In addition, as Japanese imports in the United States increased competitive pressures, expanding sourcing patterns to include production sites in Mexico began to be considered. Hence, the expansion of the operation of TNCs in the sector and the increase in national integration came as a result of corporate decisions rather than as a direct result of the requirements established.

Even ahead of the deadline for the elimination of TRIMs, domestic content requirements did not play a role in the behaviour of most enterprises. This can be observed in figure III.10, which shows that the real domestic value added for assemblers of vehicles (i.e. that reported by enterprises in the industry) was above the required levels (according to the schedule for their elimination set in NAFTA) for the entire period of 1994–2002. The gap between both values even widened from 7 per cent in 1994 to 21 per cent in 2002.[16]

Figure III.10. Required and real domestic value added in the automotive industry, 1994–2002



Source: Ministry of Economy.

Regarding domestic content in the auto parts industry, survey results reveal that it increased from 34.7 per cent in 1994 to 39.7 per cent in 1998 and 42.7 per cent in 2002 (i.e. it has been above the minimum value required) (Mortimore and Barron, 2004). There was even the expectation from the part of manufacturers to increase this value to 49 per cent by 2006. Incidentally, the same study also confirmed that the goods and services provided by Mexican suppliers had low value added. The decision to buy locally or to import depends on the strategic decisions made by the parent companies, which still rely on suppliers based in the United States.

It can then be concluded that the removal of domestic content requirements has not affected negatively the level of local sourcing in the Mexican auto industry.

At this point, it is necessary to discuss the effect of trade balancing requirements. The initial ones, established in the Auto Decree of 1977, were met with resistance from the main American firms. Once they realized that the expansion of their operations in Mexico as a strategy to reduce costs was also in their best interests, however, an increase in exports followed. Thus, in this case the establishment of the requirements by the Mexican Government acted as a catalyst for the corporate decisions to increase exports. The final decisions taken by the parent companies were again in line with their strategies at a time when they were facing a declining position in the American market.

As shown in figure III.6, the final assembly segment has shown trade surpluses. The same cannot be said about the auto parts segment, which presents persistent trade deficits. The automotive industry supply chain follows the configuration of a pyramid, where the second and third tiers represent the base of the pyramid. The final assemblers are at the top, followed immediately below by the first tier of suppliers. As firms climb the pyramid, the manufacturing complexity and technological sophistication increase. Most Mexican firms in the sector are located in the second and third tiers, with only a small concentration of domestic firms near the top (i.e. the first level) (Veloso and Soto, 2001).[17]

One of the main concerns is that the base of auto parts suppliers is dominated by subsidiaries of TNCs, especially of American origin, which import a high proportion of the inputs required from the United States (Mortimore and Barron, 2004). This reflects the relative weaknesses of Mexican auto parts firms, which still need to upgrade their technological capabilities in order to build competitive advantages rather than relying on cost-reduction strategies. Only then will conditions be set to reverse the trade deficits in the auto parts sector.

Industry representatives recognize the strong dichotomy between the final assembly and the auto parts sectors. Whereas the first is characterized by its international competitiveness, high technology levels, and high value added per worker, the auto parts segment of the industry is characterized by low technological capabilities and highly labour intensive activities. Moreover, it is estimated that average salaries are below the average for the manufacturing industry.

As mentioned, auto parts suppliers located in Mexico need to evolve from a strategy based purely on cost reduction to one based on the development of a solid base of technological capabilities and modern organizational practices. This will be necessary to achieve the goal of duplicating the automotive productive capacity for 2010 (see next section) and consolidate a true network of suppliers. Once American car makers are convinced of the development of such a network, they may begin to buy more auto parts in Mexico instead of importing them from the United States.

In interviews conducted for this study, the most important areas of improvement identified in the auto parts firms were quality improvement, ability to meet delivery times, acquisition of financial capability and an entrepreneurial culture, and technological development. In general, experts interviewed did not credit the use of TRIMs as a real force that affected the development of the sector.

Some representatives from the industry have proposed other alternatives to help improve supplier performance. One approach is to contribute to the expansion of the operations of final assemblers. For example, suppliers to Ford contributed $400 million for the development of 14 buildings that will provide parts to the newly expanded plant in Hermosillo (where Ford invested $1.2 billion). Needless to say, only the most advanced suppliers (mainly in the first tier) can adopt this strategy. Thus, the Government has a key role to attract further investments in this industry.

Finally, regarding whether the removal of TRIMs has enhanced the ability to attract FDI in the automotive industry, other reasons seem to explain the FDI surge in 2004 (see figure III.8), such as the start of the manufacture of new car models by several companies. According to officials from the Ministry of Economy, however, the elimination of TRIMs has had a positive impact on FDI inflows. Since their elimination, the productive capacity has increased and investments for $2.7 billion have been realized, generating 11,640 new jobs (Secretaría de Economía, 2004).

Investments announced by several enterprises confirm that Mexico maintains its attractiveness as an export platform. Examples of new investments planned include Ford – which will expand the capacity of its plant in Hermosillo from 100,000 to 300,000 units per year through a $1.6 billion investment, which will generate 6,800 new jobs – and Volkswagen, Toyota and Nissan, which at the time of preparing this text were in the process of expanding their operations in Mexico.

5. Substitute policy measures for TRIMs

To what extent has the Government adopted other policy measures to "compensate" for the elimination of TRIMs? Given the fact that it faces a limited range of policy instruments to implement an "activist" policy as in the past, the current approach towards the automotive industry can be characterized as relatively passive.

As discussed above, on 31 December 2003, the 1989 Automotive Decree that established TRIMs was abrogated. On the same day, the Decree to Support the Competitiveness of the Vehicle Assembly Industry and the Development of the Internal Market for Automobiles was published on the Official Journal of the Federation. The preamble of this decree recognizes the national content and trade balance requirements established in the 1989 Auto Decree as well as the need to eliminate them in order to fulfill Mexico's international compromises. It creates a registry of manufacturing enterprises.[18] The registered enterprises obtain some benefits regarding the conditions for importing vehicles, especially if they invest in human and technological development through worker training, transfer of technology to suppliers, or support for design centers. Benefits include: (a) fiscal advantages; (b) imports of supplies with preferential (low or even zero) tariffs through the Programme of Sectoral Promotion of the Automotive and Auto Parts Industry; and (c) imports of vehicles with zero tariff.

The Ministry of Economy subsequently formulated the Competitiveness Programme for the Automotive Industry, whose main objective is to consolidate Mexico as a world-class

centre in the manufacturing of automobiles in order to position the country among the five most important vehicle producers in the world (Secretaría de Economía, 2004). The goal is to achieve a production of 4 million units and an internal market of 2 million units by 2010.

The programme does not include domestic content or trade balancing requirements. Instead, its objectives include promoting the development of a greater number or suppliers, modernizing the regulatory framework, and simplifying administrative procedures. As recognized by the ministry, in the new environment characterized by a more limited "policy space" and the need to honour international commitments, five main strategies have been defined to improve the competitiveness not only of the automotive sector, but of the whole economy:

- *Reduction of costs associated with logistics* (improvement of infrastructure, including transport, telecommunications, and customs).
- *Improvement of the business environment* (streamline the regulatory framework as well as the conditions for market competition and legal certainty).
- *Improvement of the energy offer* (guarantee a reliable supply of energy).
- *Deepening of the financial system* (promote the competition among financial intermediaries and improve the regulation of the financial market).
- *Strengthening of the innovative capabilities, training and education* (implement training programmes, improve the financing of projects based on new scientific and technological inventions, and create and consolidate research groups in enterprises).

Thus, Mexico has witnessed a transition from active policies in a closed economy to horizontal (more passive) policies in a liberalized economic environment. Maintaining macroeconomic stability, improving the physical, financial and technological infrastructure, adhering to principles such as openness to international trade, non-discrimination and a transparent regulatory environment seem to be the new core principles guiding the development of the manufacturing industry in general. A more active policy approach may be required to address certain worrisome trends in the automotive industry, especially the development of Mexican suppliers in the first and second tiers of the supply chain in order to reverse persistent trade deficits.

Several strategies can be followed to help develop the local auto parts suppliers, among them:[19]

- *Increased specialization of production*. This would reduce the variety of products manufactured to focus in just a few of them so that the capabilities of each enterprise can be most efficiently applied. It would also make it possible to better exploit scale economies.
- *Fostering the development of clusters*. By encouraging the development of auto parts suppliers in close geographical proximity to each other, the advantages associated with clustering can be exploited (among them, a more flexible and dynamic labour market, an environment that facilitates informal communication and the diffusion of innovations, etc.).
- *Increasing technological capabilities and human resources training*. Technological development is a key factor in the competitiveness and ultimate survival of firms. The international dynamics of the automotive industry require that auto parts enterprises have the necessary understanding about process, materials and product technology, as well as capable human resources able to communicate and negotiate with clients.
- *Market diversification.* Traditionally, auto parts enterprises in Mexico have dealt predominantly with American auto

companies. Asian firms, however, have shown a greater dynamism in international markets than their American counterparts. Auto parts firms should begin to target Asian auto firms as potential customers in order to be part of their dynamic development. This may require learning new schemes of negotiation and sourcing.

- *Increased cooperation among industry, Government and academia.* More cooperation among these three crucial actors would allow the design and implementation of successful integral development plants for the industry. This triad has been shown to be a critical factor in the success of the industry in other countries.

During the past five years, the Mexican auto industry has experienced a deteriorating position reflected in decreased levels of production, exports and employment combined with increased imports (*Reforma* 2005a, 2005b).[20] In the end, improving this crucial industry in a post-TRIMs world will require two essential strategies: (a) deepening the local supplier base of Mexican firms and TNC subsidiaries, so that it can meet the rules of origin of the free trade agreements with Europe and Japan, currently more than 60 per cent, (This seems to be the main way to diversify markets for vehicles.); and (b) targeting specific auto TNCs for quality or for their willingness to build unique models in Mexico (such as Volkswagen's Beetle, Chrysler's PT Cruiser, etc.) for exports.[21]

Unlike the final assembly segment, where all the enterprises are foreign-owned, several Mexican firms exist in the auto parts segment. They stand to benefit from the implementation of the strategies mentioned above to become a more dynamic source of employment and exports and to contribute to the sustained competitiveness of the automotive industry.

E. Conclusions

The Mexican case provides some lessons regarding the application of TRIMs. They were widely used in several industries during the ISI efforts that took place after World War II. Their application contributed to the development of the country's industrial base by incorporating Mexican firms into the production chains of TNCs. For most of the industries where domestic content requirements were applied (e.g. the pharmaceutical and electronics industries), this result, however, proved to be unsustainable. Once requirements were eliminated, most of the contractual relationships were dissolved and the ambitious domestic content levels set in government plans were never reached. In the case of the automotive industry, conversely, domestic content levels became irrelevant since the actual values were well above those required by the regulation.

Trade-balancing requirements, however, proved to be pivotal in influencing the decision of major auto TNCs to use Mexico as an export platform. In this case, the requirement had a positive effect in causing (some would say accelerating) this change in corporate strategy regarding the role of Mexico in the international development of the industry.

Thus, the Mexican experience suggests that domestic content requirements were generally ineffective in achieving long-term and sustained improvements in performance for the companies that at some point benefited from these measures. Trade-balancing requirements, on the other hand, had a role to play not only in reducing trade deficits, but in placing Mexico in a more prominent position as platform for exports to the American market.

Annex to chapter III. TRIMs in the pharmaceutical and electronics industries

Since the use of TRIMs is highly industry-specific, for illustrative purposes, the cases of the pharmaceutical and electronics industries in Mexico are presented in this annex. Both are regarded as crucial by policymakers – the first because of its importance in the building of a national health system, and the second for its contribution to the development and consolidation of a modern industrial base. Consequently, both were targeted through the implementation of specific industrial policies where domestic content and trade balancing requirements were common. TRIMs in these two industries were never notified to WTO, however, as they had already been abolished by 1994.

Pharmaceutical industry

The Mexican Government's policies had a decisive impact on the growth and development of the pharmaceutical industry through import restrictions, tax incentives, cheap loans, associated legislation on technology transfer, foreign investment and intellectual property rights, as well as the implementation of a sectoral programme.

The 1973 Foreign Investment Law required that pharmaceutical and pharmochemical companies operating in Mexico had to be at least 51 per cent Mexican owned. Foreign firms established before the enactment of the law were exempted, but they were not allowed to enter new manufacturing activities. Regarding foreign trade regulations, Mexico had required, since the 1940s, import permits for foreign-finished pharmaceuticals. These permits were rarely granted. Trade restrictions forced TNCs to buy from Mexican manufacturers products that they themselves produced elsewhere. In 1987, some pharmaceuticals (antibiotics, antacids, vitamins) were freed from such restrictions.

From the three main pieces of legislation enacted to control the perceived high dominance of TNCs (the 1972 Technology Transfer Law, the 1973 Foreign Investment Law, and the 1976 Law on Inventions and Trademarks), the technology transfer law was considered the most successful (Gereffi, 1983). The other laws suffered from loopholes and difficulties in their implementation. The technology transfer law established a process of review of all agreements in which a foreign company charged a Mexican company for technological know-how. If the terms of the agreement were judged unfair by a registry established by the law, the transaction was not authorized and had to be redrawn and submitted in terms more favourable to the Mexican party.[22] This practice helped domestic manufacturers to select the best technological supplier, and to pay fair prices in more advantageous terms.

All these policies were enacted during the administration of President Luis Echeverría. New administrations were not willing to continue this confrontation. On the contrary, they were eager to restore investors' confidence. To this end, the dismantling of these policies began during the late 1980s. Before that, a sectoral programme was issued in February 1984.

The programme identified four main problems: (a) market domination by foreign firms; (b) dependence on external sources of technology; (c) a growing trade deficit caused by the imports of active ingredients; and (d) an excessively discretionary application of price controls, which often caused equivalent products to have different prices. Consequently, the main objectives were to achieve (a) the promotion of Mexican laboratories; (b) the rationalization of the drugs supply to the market; (c) the expansion of domestic production of

pharmochemicals in order to increase the degree of national integration and the use of the country's natural resources; and (d) the increase in exports of pharmaceuticals and pharmochemicals in order to reduce the trade deficit. These objectives were to be achieved through tax and financial incentives (domestic firms were given preference), trade protection by prior import permits, and regulatory policies regarding prices (which were to remain controlled) and FDI. Foreign companies were required to do the following: (a) not buy up national firms already established; (b) not manufacture active ingredients if this implied the elimination of firms with majority Mexican capital; and (c) achieve self-sufficiency in foreign exchange by substituting imports or increasing exports. In other words, the use of TRIMs in the form of increasing domestic content and trade balance requirements were integral parts of the programme.

However, the foreign affiliates in the industry instituted court proceedings, claiming that the decree was illegal because of the lack of exclusive rights for manufacturers to make products which they had invented, or to receive payments for technology. A settlement was reached and a revised version of the decree that gave some measure of process patent protection was issued.[23]

By the late 1980s, the discontinuance of tax incentives, credit support and trade protection signaled difficult times for Mexican firms in the industry. The new Foreign Investment Law lifted all constraints in the industry (i.e. ceilings on the participation of foreign capital were eliminated) and TRIMs in the form of performance requirements regarding value added, exports and degree of import substitution were discontinued. Also, the signing of NAFTA gave national treatment to North American TNCs.

As a result of the application of TRIMs, there is some evidence of the establishment of linkages through subcontracting agreements in the industry. Survey results for 1990 (UNCTC, 1992) reported that of seven pharmaceutical foreign affiliates, four subcontracted out parts of their production. They also provided assistance in the form of administrative and technical help, and/or quality control techniques to the other party. The interviewed firms expressed that the main motivation for undertaking subcontracting activities was to comply with local content requirements.

Results from the National Survey of Employment, Salaries, Technology and Training for 1994 reported 10 of the surveyed firms in the industry subcontracting part of their production. They had reportedly provided assistance in the form of: financing (one plant), training (four plants), technical assistance (six plants), and provision of raw materials (eight plants). However, most of these firms were domestic. So, even though TNCs' affiliates developed some backward linkages, they did so in order to comply with the performance requirements set in the sectoral programme. Once the requirements were discontinued, the affiliates chose not to continue these partnerships. Thus, the linkage effects that existed at one time proved to be unsustainable.

Electronics industry

Industrial policies affecting the electronics industry began to take shape in the early 1980s. For the computer industry, a formal development programme was formulated. For consumer electronics, the main measures adopted were those related to trade liberalization. Prior to 1981, practically all the domestic demand for computers was met with imports. Policymakers targeted the computer sector for development since they considered that the possibilities for import

substitution were high and they also regarded it (and its related technological fields) as an effective platform for future industrial development.

The sectoral policy was governed by a programme approved in 1981: the "Development Programme for the Manufacturing of Electronic Computer Systems, their Main Modules and Peripheral Equipment". Its objectives were to (a) improve the computer industry's contribution to the balance of payments and increase exports; (b) increase national integration; (c) develop a component supply industry; and (d) encourage local technological development.

In order to achieve these goals, the Government provided tax incentives and trade protection, and implemented TRIMs, especially in the form of local content requirements. Import permits were established for imports of computers, monitors, printers, keyboards, modems and memory units. Computer firms operating in Mexico were also required to have at least 51 per cent Mexican equity capital and to export an increasing percentage of their production. The decree set strict local content regulations by requiring foreign manufacturers of minicomputers to use at least 30 to 40 per cent Mexican components (set to increase over time). Foreign firms were also required to spend between 5 per cent and 6 per cent of the value of sales on research and development in Mexico.[24] Thus, the whole programme of ownership restriction, import substitution and export promotion was replicated in a single industrial policy (Whiting, 1992).

The Government's hopes that import restrictions would foster the development of a domestic supply network for components were not materialized, however. Most firms operated just above the margin of survival and they could not afford the risk of trying local suppliers. Also, since the existence of small Mexican personal computer manufacturers was protected, they could not benefit from scale economies, leading to expensive and poor quality products. In addition, the policy was not uniformly applied, and each firm had to negotiate with the Government concerning the amount of the investment, exports and local content requirements. In one such negotiation, IBM achieved an historic agreement in 1985, when the Government granted permission to retain 100 per cent ownership of its Mexican affiliate. It marked a change in the regulation of foreign investment from an emphasis on joint ownership requirements toward allowing fully-owned subsidiaries. It aimed at inducing foreign investors who were reticent to enter into joint ventures with Mexican counterparts.[25]

Apple and Hewlett-Packard had already entered the market under joint venture terms, and they strongly opposed the IBM proposal. They argued that the IBM's investment would crowd out existing producers and monopolize the market. A revision of the original proposal was submitted and approved. IBM increased its original investment and committed itself to export more than 90 per cent of the plant's output. Hewlett-Packard and other competitors soon followed suit and acquired 100 per cent ownership of its Mexican operations.

As a result of Mexico's decision to open up the country to foreign trade and its accession to GATT in 1986, the industry suddenly faced international competition and suffered a number of plant closures and loss of jobs. The Mexican consumer electronics industry was transformed from one where 50 per cent of the national demand was met with imports and the other half had 80 per cent of domestic content, to another one with 90 per cent of the demand being met with imports and less than 15 per cent of domestic content in the 10 per cent produced domestically (Warman, 1994).

In the end, the attempt to develop the industry along import-substituting lines did not produce the results anticipated. The main personal computer manufacturers were reluctant to accept minority capital shareholding positions. The rapid technological changes in the industry and the drastic fall in domestic disposable income as a result of the debt crisis were other contributing factors.

Given the characteristics of the electronics industry (mainly the need of a continuous supply of a range of parts and components whose production require different manufacturing skills), the establishment of backward linkages arises naturally as one of the main channels for the transmission of technological know-how. Small and medium-sized domestic firms had the opportunity to supply inputs to foreign enterprises. This was one of the objectives of the TRIMs in the form of performance requirements set in the past, but the Government found the local content requirements set in the 1981 computer decree impossible to enforce due to a lack of local capabilities, and less ambitious requirements had to be set (Miller, 1986; UNCTC, 1992).

According to a 1990 survey of foreign affiliates (UNCTC, 1992), of the eight affiliates producing electric and electronic equipment, six subcontracted part of their production, while the two computer firms included were involved in a subcontracting relationship. The primary reason to be involved in such agreements was to reduce costs and to simplify the operation of the plants. They also reported having provided some help to the subcontractors in the form of technical assistance, quality control or financing.

Concluding remarks

In conclusion, for the cases of the Mexican pharmaceutical and electronics industries, the initial reason for the elimination of TRIMs was a change in government strategy. In the electronics industry, the ineffectiveness of measures to achieve the proposed domestic content levels was also a factor. In addition, the intent was to create a friendly environment for foreign investors, which necessarily implied the elimination of restrictive performance requirements in most industries.

Following this brief review of the experiences of the pharmaceutical and electronics industries, it can be concluded that government intervention through the establishment of performance requirements (including TRIMs) may have accomplished to some extent its original intent: to control the behaviour of foreign companies by "forcing" them to adopt a Mexican supplier or partner. However, this occurred in a highly regulated and protected environment. Once the process of deregulation and liberalization of the economy started, domestic firms and their products could not compete with imports or with other foreign producers established in the country, denoting the lack of effectiveness of the measures implemented to develop sustainable capabilities in the Mexican industrial base.[26]

A review of the ranking of the 500 most important enterprises in Mexico in 2005[27] gives some idea about the nature of the dominance in the sectors studied. In the pharmaceutical industry, the five most important enterprises are Pfizer (No. 140), Roche Corp. (No. 142), Merck Sharp & Dome (No. 147), Bayer de México (No. 151), and Schering Plough (No. 165). All of them are foreign affiliates of TNCs. The highest ranked Mexican company is Laboratorios Pisa, at No. 258 (or No. 15 in the pharmaceutical sector). Regarding the electronics industry, the situation is similar: a clear dominance of foreign companies with few Mexican competitors.

Notes

[1] This chapter is based on a paper prepared for UNCTAD by Murillo (2006).

[2] According to data compiled by the Economic Commission for Latin America and the Caribbean (ECLAC), during the period of 2001–2004, the regional leadership regarding attraction of foreign resources has alternated between Mexico and Brazil.

[3] This was also linked to the need to protect the low levels of international reserves in the aftermath of the debt crisis.

[4] As noted by the Organization for Economic Cooperation and Development (OECD, 1996), three factors distinguish "modern" industrial policy from past practices: (a) it makes minimal use of subsidies, placing emphasis instead on facilitation; (b) it does not attempt to defend the market positions of incumbent producers that seek protection from the Government; and (c) it is not aimed at particular sectors or firms, but rather at activities believed to generate high social or private returns.

[5] The rationale for targeting SMEs is that they employ a large portion of the workforce (contributing to a more equitable income distribution), and generate positive externalities to the rest of the economy through the development of labour skills.

[6] This shift in policy formulation is discussed in Peres (1997) for several Latin American countries. He refers to the new approach as formulating "industrial competitiveness policies" to differentiate them from traditional industrial policies. Whereas the old approach aimed at creating new productive sectors, the new one aims at increasing the efficiency of existing ones.

[7] This "evaluation" process is mostly symbolic, since the same law establishes that, if no answer is given to the request within 45 working days, it can be considered automatically approved.

[8] A whole chapter of the treaty is devoted to investment (chapter XI). Regarding negotiations on this issue, the main objectives of the Mexican delegation were (ITESM, 1994): (a) to keep the activities reserved for the State according to the constitutional framework; (b) to create an environment of certainty and trust for foreign investors; (c) to generate more and higher quality jobs; and (d) to guarantee for Mexican investors in Canada and the United States the same treatment granted to North American investors in Mexico.

[9] The list of prohibited performance requirements in NAFTA (article 1106) goes beyond that of the TRIMs Agreement. Actually, United States trade agreements establish, in effect, a "TRIMs-Plus" set of obligations that includes outright bans on certain performance requirements, including exports, minimum domestic content, domestic sourcing, trade balancing and technology transfer. In addition, these provisions cover both goods and services.

[10] The rail sector was subsequently opened to foreign investment.

[11] For instance, with regard to the regulation of TRIMs specifically, the 1994 free trade agreement between Colombia, Mexico and the Bolivarian Republic of Venezuela includes, in its article 17-04, the same measures covered by the TRIMs Agreement. It states that no party shall impose performance requirements by adopting investment-related measures that are mandatory or required for the establishment or operation of an investment, or for which compliance is necessary in order to obtain or maintain an advantage or incentive. The 2000 treaty with the European Union, on the other hand, does not contain a ban on performance requirements. The agreement simply states that the existing restrictions on investment will be progressively eliminated and no new restrictions will be adopted.

[12] In 1994, the Ministry of Economy made a methodological change in the way FDI was measured. For this reason, the figure does not include inflows before this year, since they would not be directly comparable.

[13] Dunning (1992) identifies four strategies that guide TNCs' activities in host countries: (a) natural-resources-seeking; (b) market-seeking; (c) efficiency-seeking; and (d) strategic asset or capability-seeking.

[14] This notification is contained in the WTO document G/TRIMS/N/1/MEX/1. The same day a revision (G/TRIMS/N/1/MEX/1/R) was issued because the order of two pages was inadvertently reversed in the original version.

[15] This ministry changed its name to Ministry of Economy.

[16] It should be noted that, since 2004, enterprises have no obligation to report domestic content to the Ministry of Economy; consequently, it is not possible to check changes in this trend after the elimination of TRIMs.

[17] Vallejo Carlos (2005) proved statistically for the Mexican case that firms in the first tier of suppliers (i.e. those which are directly related to the final assemblers) are more likely to conduct research and development activities than firms located at lower levels of the automotive supply chain.

[18] Some of the requisites to be part of the registry and access the benefits specified in the decree include: (a) a production of at least 50,000 units

during the preceding year; (b) an investment of at least $100 million in fixed assets; and (c) brands registered in the Mexican Institute of Industrial Property.

[19] These and other proposals are explored in more detail in CEC (2004).

[20] Even though the most recent data reveal an improved position of Mexican exports to the American market (*Reforma*, 2006), the difficulties in the global auto industry persist. The main reason for the increase in the participation of Mexican exports in the American market from 6.2 to 11 per cent lies in the fact that several investment projects in Mexico to produce models for export (e.g. the Zephir and Milan from Ford, and the Silverado 1500 from General Motors) reached maturity.

[21] These two essential points were stressed by an anonymous reviewer.

[22] The Registry of Technology Transfer created by the 1972 *Law of the Registry of Technology Transfer and the Use and Exploitation of Patents and Trademarks* had as its main objective to establish an official register with the purpose of regulating and monitoring the imports of foreign technology and to strengthen the bargaining power of national enterprises. In the framework of this law, although the parties to a contract may have already reached an agreement before presenting their documents to the Registry, the Government reserved the right to reopen the negotiations. Additionally, several restrictive clauses commonly found in technology contracts were prohibited. The registry also tried to reduce the excessive duration of, or payments for, such contracts. In 1991, the *Law of Industrial Property* was enacted superseding the 1972 law and eliminating the Registry of Technology Transfer along with the regulation of technology contracts. This new law, through the Mexican Institute of Industrial Property, provides legal protection for the exclusive use of inventions and trademarks, and streamlines the process for the licensing of patents and trademarks. It is considered the main expression of the new policy favouring a more liberal environment for the transfer of technology.

[23] As noted by UNCTC (1992), the 1984 pharmaceutical programme was different from those of other targeted industries (mainly the electronics and automotive industries) in the sense that it was more typical of an import substitution policy with strong constraints on TNCs' behaviour and expansion. The main objective was to increase the national self-sufficiency for pharmaceuticals, and only secondarily to promote the internationalization of the industry.

[24] Various activities could qualify as research and development expenditures: development of machinery and equipment, the adaptation of a system, or the funding of computer research and development in authorized research centers. The type of research and development activity undertaken by the firm also had an effect on the calculation of the degree of national integration through a multiplier factor "T". Thus, a high "T" factor could offset a low value of domestic component content.

[25] See Whiting (1992) for a detailed analysis of the rationale behind the IBM decision.

[26] As one anonymous reviewer stressed, probably the main criticism of TRIMs in Mexico (and in Latin America in general) is that they were not implemented in an internationally competitive way (as compared to several countries in Asia, for example). Thus, it can be argued that it is the implementation more than the instruments per se that can be criticized.

[27] The ranking, based on sales, is from the Mexican business magazine *Expansión*.

IV. Pakistan

A. Introduction

Pakistan was one of the countries that notified investment measures under the agreement.[1] Following Pakistan's request, the initial five-year transition period was further extended to December 2002. During that time, Pakistan made an effort to eliminate all remaining TRIMs. About 85 per cent of measures covered by the so-called deletion programmes (box IV.1) have so far been abolished.[2] However, TRIMs have remained a major concern in the case of the automobile industry. A new request for a further three-year extension of TRIMs related to the automobile industry was therefore submitted by Pakistan to WTO. Pakistan asked for an extension to 2005 as its automobile manufacturing industry was seen to be in a take-off stage. By the end of 2005, the milestone of 100,000 locally-produced cars had been achieved. The industry provided some 150,000 jobs and contributed at least 10 per cent of the GDP. The industry is expected to serve as a growth engine for Pakistan's engineering industry (Engineering Development Board, 2005). At the time of writing, WTO had not taken any decision on the latest Pakistani request.

Box IV.1. Pakistan's indigenization/deletion programme

The indigenization/deletion programme of different products of the engineering industry was formulated in 1987 to promote the engineering base of the country. It aimed at facilitating the exploitation of available resources; the transfer of technology and linkages between large, medium and small-scale industries. Other purposes were to safeguard the external financial position of the economy by saving foreign exchange along with providing job opportunities. The engineering industries covered by this programme were allowed to avail a concessionary rate of duty for the import of components/subcomponents and raw materials to promote indigenization, or local production. Specific time schedules were laid down for various industries during which the concerned enterprises were asked to increase progressively their use of domestically-produced components and parts. Schedules were established in consultation with the enterprises concerned and related vendor industries, and took into account the potential of the local industrial base, the availability of technical know-how, and the facility with which transfer of technology from abroad could be arranged. Both new and existing enterprises were allowed to take advantage of the programme, but no enterprise was compelled to follow it.

The deletion programme was implemented under the statutory authority of the Federal Government under the Customs Act and the Sales Tax Act. The Ministry of Industries and Production of the Federal Government is responsible for overseeing its implementation. The programme encompassed the engineering, electrical goods and automobiles industries, and came into effect in August 1987. It does not specify a phasing-down provision. An Indigenization Committee – with representatives of the Ministries of Industries and Production, Commerce, Finance/Central Board of Revenue and Defense Production, the relevant vendor associations and the enterprises concerned – is responsible for formulating the programme, which aims to facilitate rising standards of living, increased employment opportunities and a growing volume of real incomes.

Source: UNCTAD.

This chapter analyses how the removal of TRIMs in different industries has affected the development goals of Pakistan. It is organized as follows. Section B and C review the regulatory framework and investment policies in Pakistan along with a brief description of inward FDI flows to the country. The relevant TRIMs are discussed in section D and a case study of the automobile industry is presented in section E. The chapter concludes with a summary and some policy considerations.

B. Investment policies and the regulatory framework

Pakistan has moved to an increasingly liberal investment regime in recent years. Until the late 1980s, it was more selective as regards FDI projects. The procedure for obtaining permission to set up an enterprise was restrictive, and FDI was regulated through investment licensing, with a view to ensuring optimal utilization of resources. While this led to a lengthy administrative process, proposals were practically always accepted. Thus, it served little purpose but to delay the implementation of investment projects.

Government approval for some categories of investment was considered essential to ensure that projects of national significance were established with government knowledge and involvement. Industries specified for reasons of overcapacity, price regulation and implementation of a programme of assembly-cum-manufacture were required to get government approval. Projects involving foreign private investment and those costing Pak rupees (PRs) 300 million or more also required government permission. Foreign private investment was encouraged in the form of joint equity participation with local investors and in areas involving advanced technology, managerial and technical skills, and marketing expertise.

The Investment (Promotion and Protection) Act of 1976 provided enhanced security against expropriation and, in case of expropriation, guaranteed adequate compensation. It also provided for the remittance of profits and capital, and relief from double taxation for countries with which Pakistan had such an agreement. Foreign investment was encouraged in industrial projects involving heavy capital outlays, such as engineering, basic chemicals, petrochemicals and electronics. In order to encourage FDI in export-oriented industries, an Export Processing Zone (EPZ) was set up in Karachi. The concessions and facilities offered by the EPZ included duty-free imports and exports of goods and tax exemptions. Despite these incentives, the regulated nature of the economy remained a deterrent to FDI.

At the end of the 1980s, Pakistan began to implement a more liberal foreign investment policy as part of an overall economic reform programme. A new, market-based industrial policy package was introduced in 1989. A number of policy and regulatory measures were taken to improve the business environment in general and to attract FDI. A Board of Investment was set up to help generate opportunities for FDI and to provide services to investors. A "one-window facility" (or one-stop shop) was established to overcome difficulties in setting up new enterprises. The requirement of separate authorization for each investment project was eliminated in May 1991. In general, no special registration was required for FDI, and the same rules and regulations were applied to FDI as to domestic investors (Esfahani, 1995).

The requirement for government approval was removed except in the case of a few industries, such as arms and ammunition, security printing, currency and mint, high explosives, radioactive substances and alcoholic beverages. These industries were also closed to domestic private investors. In all other industries, foreign equity participation of up to 100 per cent was allowed and foreign investors were permitted to purchase equity in existing industrial companies on a repatriable basis. In non-industrial sectors, FDI was excluded from agricultural land, forestry, irrigation, as well as real estate including land, housing and commercial activities. A so-called no-objection certificate was required only for FDI in a few areas that are in the negative list of the relevant provincial Government.

One of the most important measures taken recently by the Government affecting FDI has been the liberalization of the foreign exchange regime. Residents and nonresident Pakistanis and foreigners are now allowed to bring in, possess, and take out foreign currency, and to open accounts and hold certificates on foreign currency. The Pakistani rupee was made convertible on 1 July 1994. The ceiling earlier imposed on contracting foreign loans was also abolished. Government permission would not be required regarding interest rate or payment period of foreign loans not guaranteed by the Government. Foreign currency account holders were also allowed to obtain rupee loans with foreign currency account balance as collateral.

An extensive set of investment-related incentives has been introduced including credit facilities, fiscal incentives and visa policy. Foreign-controlled manufacturing companies exporting 50 per cent or more of their production can now borrow unlimited working capital. Other foreign-controlled manufacturing companies, including those not exporting and selling in the domestic market, can borrow rupee loans equal to their equity without prior FDI in non-industrial sectors. This is not necessarily subject to the same treatment as domestic investment (see UNCTAD, 1994). Prior permission of the State Bank of Pakistan is no longer required for raising domestic credit to meet the fixed investment requirement.

Foreign investment in Pakistan is protected through the Constitution (article 24) as well as through specific laws. Section 8 of the Protection of Economic Reforms Act 1992 provides legal cover to foreign investment. In the new investment policy announced in 2005, the legal cover was strengthened to facilitate more foreign investment. To expand the industrial base, the new policy focused on the development of infrastructure along with software development to promote the electronics, engineering, agro-food, value added textile, tourism and construction industries. Foreign investment on a repatriable basis is now allowed in agriculture, services, infrastructure, and social sectors, subject to certain conditions.

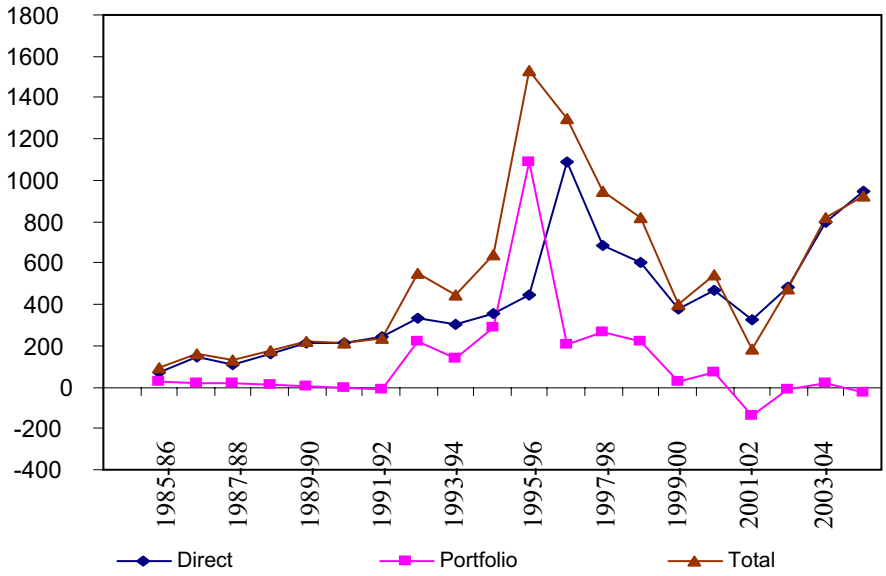
Notwithstanding significant deregulation and various incentives/ concessions given to foreign investors, Pakistan still faces problems in terms of the implementation of FDI policies and in conveying a business-friendly image.

C. FDI trends and sectoral distribution

Pakistan has lagged behind in attracting foreign investment because of macroeconomic instability, inconsistent economic policies, inadequate infrastructure and excessive bureaucratic controls on the decision-making process (Khan, 2000). Prior to 1991/92, portfolio investment was low and volatile (figure IV.1). However, with the beginning of liberalization policies in 1991/92, portfolio investment crossed the $1billion mark in 1994/95. The comparison before and after reforms shows an average trend of $182 million during 1991/92 to 1997/98 as against an average flows of only $9.0 million prior to reform (1984/85 to 1990/91). After that period, however, portfolio investment fell sharply again.[3]

The amount of FDI rose from $70 million in 1984/85 to $1.1 billion in 1994/95, but declined again to $890 million in 2004/05. With the beginning of the liberalization programme (from 1991/92) inflows grew at a compounded growth rate of 15.2 per cent. The surge in 1995/96 was mainly due to the investments in the power sector. FDI, on average, accounted for 80 to 85 per cent of the total investment inflows over the past two decades.

Figure IV.1. Inflow of foreign investment in Pakistan
(Millions of dollars)



Source: State Bank of Pakistan.
Notes: Direct investment consists of cash, capital equipment brought in and reinvested earnings.

The sectoral distribution shows that the power, chemical, transport, textile and financial business sectors dominated FDI inflows from 1997 to 2005 (table IV.1).

D. Trade-related investment measures in Pakistan

Pakistan has used some TRIMs to induce foreign firms to meet a minimum level of performance in various areas (table IV.2).

Pakistan has linked tariff exemptions with local content requirements in a number of industries, including automobiles, electronic goods, electrical goods and machinery. It notified WTO of the elimination of most of these TRIMs as of 2005. However, TRIMs and other investment measures are viewed as domestic issues in Pakistan as the mandate of WTO is perceived to be confined to trade but not investment issues. This view is based on the fear that the country would be deprived of a major means of exercising control over foreign firms operating locally if their right to impose TRIMs or other investment measures were removed. Some of the policies, such as local content requirements, are considered essential industrial policy tools. It has been argued that their use effectively links FDI with domestic economic activities. Pakistan therefore wants to use TRIMs flexibly in pursuit of various development objectives. The Government believes that the TRIMs Agreement established uniform obligations for all members and does not take account of structural inequalities and disparities in levels of development, differences in technological capabilities or of differing social, regional and environmental conditions. In short, the agreement is not seen to incorporate a meaningful development dimension. Moreover, from the national standpoint, it is not clear that the implementation of an agreement as a priority represents the best use of the limited resources and political goodwill available to the Pakistani Government (Government of Pakistan, 2005).

Table IV.1. Inward FDI to Pakistan, 1996–2005, by industry
(%)

Industries	96/97	97/98	98/99	99/00	00/01	01/02	02/03	03/04	04/05	Total
Power	244.8	239.5	131.4	67.4	40.3	36.4	32.8	14.2	73.3	861.7
Chemical, pharm. & fertilizer	51.7	72.1	54.1	119.9	26.3	17.8	92.4	28.5	89.0	570.9
Construction	14.5	21.5	13.9	21.1	12.5	12.8	17.6	32.0	42.7	194.8
Mining & quarrying – oil explor.	37.7	99.1	112.8	79.7	84.7	274.8	188.2	203.5	194.3	1 314.6
Petrochemical & refining	1.5	1.6	38.8	12.0	8.7	5.0	3.0	72.4	24.8	174.2
Food, beverages & tobacco	51.5	19.1	7.4	49.9	45.1	5.1	7.0	4.5	22.9	207.0
Textile	12.4	27.3	1.7	4.4	4.6	18.4	26.1	35.4	39.3	173.3
Transport, storage & comm. it	6.4	10.2	33.3	31.0	81.5	35.2	114.1	230.7	531.9	1 138.0
Machinery other than electrical	2.0	-	0.9	3.1	0.3	0.1	0.4	0.7	2.8	10.7
Electronics	-	2.7	1.2	2.3	2.8	15.9	6.7	7.5	10.3	53.2
Electrical machinery	4.1	8.7	1.9	1.5	2.1	10.5	10.5	8.7	3.4	51.6
Financial business	106.5	20.4	24.4	29.6	34.9	3.5	207.5	242.1	269.4	887.6
Trade	-	12.6	5.5	7.6	13.2	34.2	39.1	35.6	52.1	220.3
Tourism / paper & pulp	7.4	5.7	-	0.7	1.4	0.8	1.5	1.8	-	19.9
Cement / sugar	49.4	3.0	2.0	6.1	15.2	0.5	1.3	2.3	17.3	100.4
Others	92.2	57.8	43.0	33.6	18.6	23.9	49.8	57.9	150.5	551.7
Total	**682.1**	**601.3**	**472.3**	**469.9**	**322.4**	**484.7**	**798.0**	**949.4**	**1 524.0**	**6 529.9**

Source: Board of Investment (BOI), Government of Pakistan (2005).
Note: Industries in the table are not ranked by any order.

Table IV.2. List of TRIMs

TRIMS and their objectives	*Application status in Pakistan*
Local content requirements (LCRs) - Requiring that a certain amount of local inputs be used in production.	LCRs have been used as part of the deletion programme.
Trade-balancing requirements - Requiring that imports should be a certain proportion of exports.	**Import of items, which are banned for import (such as explosive material, alcohol etc.)** and are required for actual use in the manufacture of goods for export is allowed from worldwide sources against cash up to the percentage of the f.o.b. value of export to be determined in each case and subject to the conditions laid down from time to time and authorization issued by Export Promotion Bureau.
Foreign exchange balancing requirements - Requiring that the availability of foreign exchange for imports should be a certain proportion of exports and other foreign exchange brought in by a firm.	In Pakistan there is free access to capital markets and there is no restriction on repatriation of income by a firm principal dividends etc.
Exchange restrictions - Restricting access to foreign exchange and hence restricting imports.	Foreign exchange controls have been relaxed.

Source: Khan (2000).

1. Pakistan's commitments under the TRIMs Agreement

Under article 5.1 of the TRIMs Agreement, Pakistan notified its indigenization/deletion policy to WTO in 1995.[4] The notification explained that this programme falls under paragraph 1(a) of the illustrative list to the agreement on TRIMs and that it is:

> "*...designed as a framework for providing incentives to promote the establishment and development of industries in the country. It is aimed at facilitating the exploitation of available resources and transfer of technology; at promoting linkages between large, medium and small industries and safeguarding the external financial position of the economy.*"

The notification further mentioned that there is no compulsion for enterprises to follow the deletion programme. Those who opt for it are, however, entitled to concessionary tariff rates. The programme was designed specifically for engineering, electrical goods and automobile industries. It did not specify any phasing-out provision.

On 28 December 1999, the Government sought an extension of the transition period for another four years under article 5.3 of the agreement. The reason given by the Government of Pakistan was the usefulness of the programme. The request stated that:

> "*The industries which opted for the programme have significantly benefited in economic terms. Not only large industrial enterprises, but also vending industries which consist of small and medium-size enterprises have greatly benefited from the programme. There have also been accompanying social benefits, including job creation and uplift of underdeveloped areas.*"[5]

It further said that:

> "*The industries that have opted for the programme are at various stages of implementation of the programme. Abolition of the programme in the present circumstances would be detrimental not only to these industries but would also adversely affect many of those enterprises having forward and backward linkages with these industries. It would further have negative impact on investment, balance of payment situation, and would impede the process of technology transfer which is presently underway.*"

The deletion programme is considered to have been of great importance to Pakistan also from a social point of view. Its removal was therefore expected to result in displacement of labour and increased underemployment (Engineering Development Board, 2005). Currently, Pakistan is going through a phase of high unemployment. The jobs created by the vendor industries associated with industries implementing the deletion programme helped to reduce the level of unemployment. In light of the above considerations, Pakistan sought the extension of the programme for seven more years from 2000. The Council for Trade in Goods decided to extend the transition period for Pakistan for the elimination of TRIMs notified under article 5.1 of the TRIMs Agreement until 31 December 2001, and allowed Pakistan to request another extension of not more than two years. Pakistan subsequently requested, and was granted, the extension until 31 December 2003.[6]

During the transition period, Pakistan eliminated many of its TRIMs. As of early 2006, 86 programmes relating to machinery and domestic appliances had been removed. However, Pakistan faced difficulties in phasing out the remaining 16 programmes, which were all related to the auto industry. After availing itself of five years of normal transition period and three years of special

extension, Pakistan sought a further extension of three years for maintaining its programme for this industry. Earlier, the extension granted to Pakistan from the WTO Council for Trade Goods up to 31 December 2003 was for a complete phase-out of deletion programmes in order to be fully compliant with the TRIMs Agreement. Before the expiry of the special extension, Pakistan approached WTO through the Ministry of Commerce for another extension of three years up to December 2006. At the time of writing this chapter, a decision on this request was still pending at WTO.

2. Pakistan's progress on the elimination of TRIMs

Local content requirements are the TRIMs that have been most frequently used in the engineering and auto industries of Pakistan. Under the indigenization/deletion programme for these industries, companies are obligated to use a certain amount of local inputs in production. The deletion programmes for engineering products were formulated and implemented since 1987 against the backdrop of the fact that the engineering industry was noncompetitive, due to a lack of technology, raw material, trained manpower, vendor capacity and economies of scale.[7]

Considering its growth potential, engineering goods production has been accorded top priority in the successive industrial policies and a number of incentives announced to attract FDI in the industry (Board of Investment, 2004b). At the same time, a comprehensive deletion plan was also worked out for the industry to move towards more indigenization. In the production of engineering goods, foreign firms were encouraged to invest in the country through joint ventures and technical collaborations with local firms. These collaborations were helpful for the local industry to increase the share of engineering goods in the total exports, employment and overall GDP. As a result of the TRIMs, the local content in many engineering products started increasing and in certain engineering subsectors, local content reached around 80 per cent.

In 1995, the Government set up the Engineering Development Board for providing policy direction and impetus for growth of the engineering sector. The board used an integrated approach by focusing on the overall development of all the subsectors of the engineering industry and acted as a bridge between the Government and the entrepreneurs/investors to ensure achievement of set objectives. The board principally agreed to remove all the TRIMs in the industry to make it more competitive. On its recommendations, a plan was chalked out to phase out slowly the deletion programmes by 2000. Slow implementation stretched the plan slightly and the programmes in 86 products were phased out from the purview of deletion policy between 30 June 2002 and 31 December 2003. Since then, there is no deletion programme for the engineering industry (Government of Pakistan, 2004).

The TRIMs used in the subsectors of the engineering industry have been helpful in a number of ways. The contribution of the engineering industry to the economy and employment has increased. It currently contributes about $2 billion to the GDP of Pakistan and employs more than 600,000 people. The share of engineering goods in Pakistan's exports is around 3 per cent. Pakistani exports of engineering goods were $270 million in 2004. These are expected to rise to $1.5 billion in the next five years. In terms of import substitution, Pakistan saves $3.75 billion per annum. The trade deficit, which in the first nine months of fiscal year 2005/06 reached $6 billion, has been attributed mainly to the imports into the engineering industry, which accounts for more than $3 billion. These imports mainly comprise machinery and raw materials to build the local engineering industry on modern lines to meet the rising demand (local

and international) of engineering goods. The present share of the local engineering industry in meeting the total demand is 25 per cent (expected to rise to 35 per cent in the next five years).

The vendor development programme of the engineering sector has helped local industry to move towards the production of quality products for local industry and exports. Under this programme, firms producing engineering goods are required to develop components locally or use components made by local industry. A healthy vendor industry is emerging in different parts of the country due to the programme. Locally produced components are increasing in production, helping the industry to achieve economies of scale and increasing vendor capacity.

The phasing out of Pakistan's deletion programme should not be a difficult task, as it has already achieved its objective to a significant extent. The local content achieved is 100 per cent in the areas of transformers, electric motors, and pumps.[8] In the case of tractors, electricity meters, sugar plants, deep freezers, refrigerators, air conditioners, fruit juice extractors and electric irons, it ranges between 70 per cent and 90 per cent. The subsectors in the automobile industry with less than 80 per cent local content include trucks and buses (58 per cent), motorcycles (72 per cent) and motor vehicles (64 per cent). However, the remaining indigenization could be achieved through the provision of incentives rather than local content requirements.

Pakistan is complying with the TRIMs Agreement as far as engineering goods are concerned, while still watching out for the interest of local industry. The Government is also moving ahead in the auto industry to phase out the deletion programme in the minimum required time. The elimination of TRIMs is therefore almost completed. The industry is moving to a higher technological orbit from the transfer of technology. Other benefits are trained manpower and an uninterrupted supply of raw materials. The exports are also increasing thanks to the integration of local products in the international supply chain (Government of Pakistan, 2005).

According to the Government, the deletion policy in the auto industry has played a significant role and contributed to the country's economy in the form of employment creation, technology transfer, revenue contribution, GDP contribution, savings in foreign exchange, increased foreign and local investment, training and manpower development. As a result, the automobile industry has shown accelerated growth over the years. The industry is gradually moving to maturity and the elimination of TRIMs is not expected to affect its performance in a major way (Government of Pakistan, 2005). The full implementation of the TRIMs Agreement is also expected to imply that FDI into Pakistan will grow at a faster pace and its positive implications for the economy in terms of real growth, employment and the balance of payment will be significant. The examination of the automobile industry in the following section highlights the progress made.

E. Automobile industry and elimination of TRIMs

1. Automotive production trends

Automobile production in Pakistan is essentially an import-substitution industry catering to the domestic market and comprising original equipment manufacturers (OEMs), component producers (vendors), sales dealers and after-sales services.[9] At present, there are four main assemblers of cars and three main assemblers of motorcycles in Pakistan. They produce cars and motorcycles of various cylinder capacities. While there are different brands of cars, their features are relatively similar and

there is very little difference in price. Domestic prices of all cars and motorcycles are generally above world market prices.

The OEMs produce completely built units (CBUs) and some components, while the remaining components are acquired from vendors or imported. Component manufacturers generally have agreements with various OEMs and sometimes joint ventures with foreign firms, but generally have technical assistance agreements with the collaborating foreign firms.[10] The value of gross production in the automobile industry in 2004 was PR 70 billion. Its contribution to GDP has been estimated at around PR 22 billion.[11] The manufacturers claim that the industry contributes roughly PR 31.4 billion to the national budget (Pakistan Automobile Association, 2005). The assemblers provide employment to 10,000 persons and the vendor industry employs 116,200 persons.

Table IV.3. Manufacturing of automobiles

Year	Cars and jeeps	LCVs	Motorcycles	Trucks	Buses	Tractor
1989/90	27 328	11 609	92 783	1 715	626	19 376
1990/91	27 962	11 862	98 647	2 059	843	13 753
1991/92	30 685	11 411	97 162	1 627	1 114	9 817
1992/93	28 269	11 478	95 763	2 222	1 177	17 127
1993/94	20 330	5 128	63 958	1 394	427	14 907
1994/95	22 265	5 154	60 960	703	312	17 144
1995/96	33 353	6 834	121 809	3 030	438	16 093
1996/97	34 254	9 817	117 188	2 916	362	10 417
1997/98	34 340	9 886	96 991	1 850	425	14 144
1998/99	39 304	8 079	93 167	1 131	1 220	26 885
1999/2000	32 841	6 656	94 881	977	1 508	35 038
2000/01	40 032	6 965	117 858	952	1 337	32 553
2001/02	41 171	8 491	133 334	1 141	1 099	24 331
2002/03	63 267	12 174	176 591	1 954	1 346	26 501
2003/04 (E)	100 000	15 000	350 000	3 000	1 500	34 000
2004/05 (P)	140 000	18 000	500 000	3 500	2 200	40 000

Source: Pakistan Statistical Year Book 2004, Federal Bureau of Statistics and for the last two years, the manufacturers. E is used for estimated figures and P for provisional figures.

Until 2002/03, the automobile industry of Pakistan stagnated and showed wide fluctuations because of frequent changes in government policies regarding the import of vehicles. For example, under the Yellow Cab scheme, the CBUs were imported with low duties and thus the demand for locally produced vehicles slumped from 30,685 cars in 1991/92 to 20,330 cars in 1993/94 (table IV.3). From 1994/95 to 1999/2000, demand increased to around 33,000 cars. More recently, production has grown significantly. Annual growth rates in 2003/04 for different types of automobiles were as follows: 58.1 per cent for cars, 23.2 per cent for light commercial vehicles (LCVs), 98.2 per cent for motorcycles, 53.5 per cent for trucks, 11.4 per cent for buses, and 28.2 per cent for tractors. The manufacturers expected a further sharp increase in 2004/05 (Government of Pakistan, 2005).

Despite the recent sharp increase in the production of cars and jeeps, the market is still too limited for producers to achieve a minimum efficient plant size. For example, India produced 794,450 passenger vehicles

during 2002/03, out of which passenger cars accounted for 588,628; by 2011-12, the total production of passenger vehicles in India is forecasted to reach around 1.5 million, of which about 1.2 million shall be passenger cars. As a comparison, Pakistan's projected output of 140,000 cars and 18,000 LCVs for 2004/05 is very small. Moreover, the passenger-car market is shared between a larger number of OEMs, which tends to raise the cost of production of each of them. Except for Suzuki Mehran and Toyota Corolla, production of each brand was less than 10,000 units in 2002/03 (table IV.4). A reduction in the number of different models and sizes may help improve efficiency by increasing the production volume.

Table IV.4. Production of cars by brands

Brands	2001/02	2002/03
Honda Civic	4 615	4 610
Honda City	3 386	3 786
Suzuki Baleno	1 240	2 608
Suzuki Khyber/Cultus	5 441	8 097
Suzuki Alto	2 816	4 775
Suzuki Mehran	10 143	16 748
Toyota Corolla	5 763	12 861
Daihatsu Cuore	2 845	4 580
Datsun Sunny	81	51
Kia Spectra	2 091	384
Kia Classic	--	459
Kia Sportage	513	820
Santro Plus	16 667	3 114

Source: Pakistan Statistical Year Book 2004, Federal Bureau of Statistics.

The sharp increase in demand for automobiles in the past couple of years has resulted from improved availability of consumer finance for the purchase of automobiles. Increased demand has led to greater output through better capacity utilization. However, there is still an excess demand for locally manufactured automobiles. There are supply bottlenecks and only the additional investment can remove them. Bottlenecks also exist because of the inability of vendors to supply components in required quantity.

2. Japanese investment in the Pakistani auto industry

Some major international auto companies, especially from Japan, have invested in Pakistan. Nearly all their imports have been replaced by local production. There is an extensive local vendor industry producing a wide range of components, and some component producers are even exporting to other countries.[12] With the recent accelerated growth of demand, production of cars and components and employment in car manufacturing has expanded rapidly and large new investments are under way. There have been impressive transfers of technology and technological know-how, with benefits that go well beyond the car assembly and component industries. This has been due especially to the efforts of the Japanese TNCs, which have been active in sending workers, supervisors and managers for training in Japan, brought Japanese technicians and managers to work in the Pakistani plants, and provided technical, marketing and financial support and training for Pakistan-owned component producers (Government of Pakistan, 2005).

3. Policy environment

Although Pakistan allows the imports of CBUs, few new cars have been imported due to prohibitive import duties ranging from 75 per cent to 150 per cent until 2003/04.[13,] While a reduction of import duties in the 2004/05 budget in the range of 50 to 100 per cent may seem steep, the remaining tariffs will still be high enough to preclude the import of cars. After the reduction, producers have not been compelled to reduce their prices nor has there been any reduction in the premium on various brands of cars.

While imports of new cars are allowed in principle, imports of second-hand

cars are officially banned, except under the Gift Scheme and the Transfer of Residence (TR) Scheme. For 22 months with old cars, depreciation of 50 per cent can be claimed. Almost 19 per cent of all cars are imported, new and old, under these two schemes. It was expected that, because of lower import duties and 50 per cent depreciation of 22-months-old cars, the imports under TR and gift scheme would surge. However, because of the depreciation, rules have been changed and the determination of the import duty would no longer be invoice-based and as such the incidence of the duty may have gone up on second-hand cars.

As per the new rules, the depreciation allowed up to 1,800 cc shall be 1 per cent for each completed month calculated from the date of first registration abroad until the date of entry into Pakistan, subject to a maximum of 50 per cent. For 1,800 cc and above, the monthly rate is 2 per cent subject to a maximum of 50 per cent. The duty rates for second-hand cars are presented in table IV.5.

Table IV.5. Duty and taxes in Pak rupees

Vehicle	Duty and taxes in Pak rupees
Up to 800 cc	4 000
From 801 cc to 1000 cc	5 000
From 1,001 cc to 1,300 cc	10 000
From 1,301 cc to 1,600 cc	18 000
From 1,601 cc to 1,800 cc	22 000

Source: Central Board of Revenue, Ministry of Finance, Government of Pakistan, 2005.

As mentioned above, in 2003/04, an anomalous situation arose when the import duties on parts were reduced to 25 per cent but the assemblers were obliged to import CKD kit at 35 per cent. Therefore, producers not bound by deletion agreements could import parts at 25 per cent and assemble cars and motorcycles at lower production cost compared to the organized producers. Since vehicles not approved by the Engineering Development Board could not be registered with the traffic authorities, assembly based on imported components has not been significant. The duty structure prevailing in 2003/04 and 2004/05 is shown in table IV.6.

Table IV.6. Import duty structure on automobiles

	Tariffs (%)			
OEMs vehicles (new)	CBU*		CKD	
Cars and Vans	2003/04	2004/05	2003/04	2004/05
Up to 1,000 cc	75	50		
1,001 to 1,500 cc	100	50		
1,501 to 1,600 cc	125	70	35	35
1,601 to 1,800 cc	125	80		
1,801 and above	150	100		
Motorcycles	90	90	30	30
Trucks	60	60	20	20
Buses and coaches	20	20	20	20
LCVs	60	60	20	20
Tractors	30	30	0	0
Component producers				
Components deleted from CKDs (only for OEMs)	75, 100, 125	50, 70, 80, 100		
Spare parts tariffs	25	35		
Key raw materials – steel, plastics	20 or 25	10, 10		
Key raw materials with subcomponent deletion	5	5		
Machinery	5	5		

Source: Central Board of Revenue, Ministry of Finance, GOP, 2005.
* CBU capital value tax on imports: 3.75%, 5%, 6.25%, 7.5%, and sales tax 15%

4. The deletion programme and the TRIMs Agreement

The deletion programme for the auto industry started in 1983, with a revised policy announced in 1987. Assemblers setting up automobile units in Pakistan were required to replace imported components by local sourcing either by manufacturing them in-house or buying them from local suppliers. In 1995, in the Engineering Development Board, a Committee on Indigenization was formed. It developed the Industry Specific Deletion Programmes (ISDPs) and the Unit Deletion Programme. The ISDPs specify the cumulative deletion required for cars and other automobiles of different cylinder capacities in various years. The ISDPs were published and OEMs could decide which components to source locally, as long as the proportion prescribed was met. The ISDPs allocated a percentage to each of the components in the total CKD kit. These percentages were arrived at by taking into consideration the average prices of components of various makes prevailing at the time when the ISDPs were designed.

Assemblers who failed to follow the programme had to import the component at the CBU rate of import duty. Sometimes, over and above the CBU import duty, penalties were also imposed if the assemblers did not adhere to the deletion programme. New firms were given two years to catch up, but they had to start with a minimum deletion level prescribed by the Engineering Development Board.[14] Under the Unit Level Deletion Programme, assemblers could choose from which components they would like to delete from the list of CKD items. They had to meet the required target aggregate deletion percentage for car models in a certain cylinder capacity group. This target is a function of time and aggregate production of all the models in the group. As an incentive for increased indigenization, a formula rewarded assemblers that exceeded the group target with a reduction of the tariff they paid on their imported CKD packs (35 per cent at present). Credits towards the deletion percentages were also awarded for exports.

Similar to the OEM assemblers, component manufacturers also followed a deletion programme. Initially, they imported sub-components for producing the components but they gradually had to produce the sub-components as well. Sometimes, they also had vendors who provided them the sub-components. As long as they followed the programme, they were allowed to import their raw materials and intermediate products duty-free.

The policy has been successful in the sense that indigenization levels now range from 56 to 70 per cent for cars and from 81 to 88 per cent for motorcycles (table IV.7).[15] However, while the deletion levels ranged from 56 to 70 per cent, the cost of remaining CKD was almost twice the cost of locally-procured components.[16] Whereas this suggests that the cost of deleted components is low, because of the quality differential, it is not certain how efficient the deletion has been. Higher costs of CKD kits may reflect transfer pricing, lower prices of components produced in the domestic market, or higher percentages allocated to deleted products.

Table IV.7. Deletion programme and cost of CKD
(%)

	Deletion levels	CKD Cost*	Cost of domestic components
Bikes	81–88	73.8	26.2
Suzuki car	56–70	65.3	34.7
Honda car	56–70	72.4	27.6
Toyota car	56–70	65.0	35.0
Dewan car	56–70	65.0	35.0

*CKD cost includes the import duty.

Source: Automobile Manufacturers Association, 2005.

The indigenization (deletion) policies have acted as non-tariff barriers to imports, as they did not allow the import of deleted parts. Whereas it is difficult to determine the extent to which the programmes have acted as effective barriers, it seems that the programme has become redundant. Firstly, both assemblers and component manufacturers pointed out in interviews that, even after the abolition of the programmes, subcontracting relationships will be maintained because the domestic prices are lower compared to prices of imported components, and because the supply is assured. That a number of component manufacturers have been able to export also indicates that domestic prices would be below the international market prices. Secondly, although the duty on spare parts has been lower than those on CKDs over the past year, domestic producers have still been able to compete. Nevertheless, OEMs are not allowed to import the deleted components. The landed cost of some of the components, especially those requiring large volumes, may also be lower than the domestically produced components.

The 2004/05 budget provided for differentials in imported duties on raw materials, sub-components and intermediaries, sub-assemblies and assemblies, and components with import duty rates of 5 per cent, 10 per cent, 20 per cent and 35 per cent, respectively. This cascaded tariff structure would result in the dispersion of effective protection rates and may result in production of those components in which the country may not have a long-term comparative advantage and thus resulting in inefficient production structure. Since the differences in various sub-processes are sometimes blurred, it may also open the way to corruption.

5. Future course for the auto industry in Pakistan

The Pakistani auto industry is expanding at a rapid pace. A robust growth of 30 per cent was recorded only in 2004/05 (Government of Pakistan, 2005). With rising demand and additional capacity, production of passenger cars, motor bikes and other vehicles is expected to increase further. Pakistan has to build on the strengths and weaknesses of the sector and ensure that it has an efficient, low-cost and progressive auto industry. The foreign auto companies have demonstrated that they are willing and able to transfer technologies and management, marketing and other skills to Pakistan. Pakistan's labour force, including unskilled workers, skilled technicians, supervisors, managers, and entrepreneurs, both in the assembly companies and in the component industry, have also adapted well to changes that are under way.

Pakistan has to ensure a viable auto industry so that domestic producers are able to compete with imported products. The reduction in import duty rates in the 2004/05 budget may not be sufficient to bring competition from imported products and to force producers to take a long-term view. It is imperative that a detailed policy framework for the next 5 to 10 years is provided to investors for optimizing the overall economic growth. Such a framework should encompass all stakeholders – including consumers, assemblers and component producers who are interested in profitable, growing and reasonably stable production conditions – and the Government.

For realizing the objectives of an efficient automobile industry, the Government may continue to rationalize the tariff structure and eventually let the industry

be free from local content requirements. The trade policy framework could consist of a gradual reduction in tariff rates and eventually mildly cascaded tariff rates applied to imports of built up cars, SKD units, CKD units, components and replacement parts. The removal of TRIMs has shown positive results in the development of the industry; therefore, remaining TRIMs must be eliminated in the shortest possible time to achieve maximum advantage. Normal drawback and other export facilitation measures can also apply to the auto industry exports. The Government may introduce a tariff reduction on CBU and CKD imports. In the not-too-distant future, duties on all types of cars and the parts should be made uniform. Such an announcement may provide a framework to investors for an optimal investment and production mix.

F. Summary and conclusions

Inflows of FDI into Pakistan are relatively modest, despite the significant steps taken to liberalize and privatize. Over the past two decades, Pakistan has significantly reformed its regulatory framework; it has privatized a number of public enterprises and intends to privatize the remaining ones, including utilities, some of which may still be considered natural monopolies. Reforms in the financial sector have been significant. Similarly, supervision by the Securities and Exchange Commission has helped to improve investor confidence.

Pakistan has traditionally used some TRIMs to protect and develop its industry. It maintained links between certain tariff exemptions and local content requirements in a number of industries, including automobiles, electronic goods, electrical goods and machinery. It notified to WTO the elimination of most of these TRIMs in 2005. The reason for continuing some of them – especially the deletion programme for the auto industry – was their deemed usefulness. The Government believed that the industries which opted for the programme had significantly benefited from it, while the country as a whole benefited through job creation and support for underdeveloped areas. Against this background, the Government maintained that the abolition of the programme would be detrimental to the industries concerned and the economy.

Pakistan has so far successfully deleted 86 programmes relating to machinery and domestic appliances. However, difficulties were encountered in phasing out 16 programmes related with the auto industry. Slow movement on this front was justified by the need to help local vendors prepare themselves to compete in domestic and international markets.

Thus, at the time of writing, only the automobile sector was still following the Indigenization/Deletion Policy. It has made contributions by providing employment, technology transfer, revenues and GDP growth, foreign exchange savings, increased foreign and local investment, training and human capital development (Government of Pakistan, 2005).

The TRIMs used by Pakistan in different industries played an important role in the overall industrial development. The main benefit of the TRIMs has been the local production of engineering, electrical and electronic goods. There was no vendor development in the early phase of industrialization. With the help of the deletion programme, Pakistan has moved from small-scale to large-scale production. The development of infrastructure, the production base, and skilled labour in the particular fields has been credited to the TRIMs. The local automobile industry is another significant beneficiary because production of parts by local vendors has substantially reduced the price of vehicles and local producers of automobiles have earned good profit. It is now time for the

Pakistani automobile industry to move into the export market after meeting the local demand. The benefits of TRIMs enjoyed by the industry should be enough to enable the industry to stand on its own feet rather than looking towards the Government for support in terms of tariff and non-tariff measures. The overall effect of the phasing-out of the TRIMs should therefore be good for the industry and force it to become competitive domestically as well as in the international market.

Notes

[1] This chapter is based on a paper prepared for UNCTAD by Nasir (2006).

[2] Local content requirements are contained in deletion programme. Under a deletion programme, entrepreneurs undertake to utilize a progressively higher proportion of domestically produced components in the production of certain products, subject to specific incentives in the form of concessionary tariffs on imports of raw materials and other components.

[3] The State Bank of Pakistan publishes direct and portfolio investment separately from 1984/85 onwards.

[4] See WTO doc. G/TRIMS/N/1/PAK/1, 7 April 1995.

[5] See WTO notification G/C/W/173, 11 January 2000.

[6] See WTO notification G/L/466 dated 7 August 2001, G/C/W/294 dated 31 August 2001 and WTO decision notification G/L/501 dated 9 November 2001.

[7] Because of the small scale of production, the local industry was not in a position to lower the cost of production and enjoy economies of scale.

[8] The list of deletion-free commodities by 2003 includes: electronic calculators, microwave ovens, caller line identification apparatus, car cassette/stereo players, cassette players, pocket size cassette players, compact disc players, hi-fi systems, VCR/VCPs, laser video disc players, digital video disc players, cellular/mobile telephones, radio and cassette players, television sets, reception apparatus for receiving satellite signals of a kind used with television and cameras.

[9] Agreements with OEMs did not include any condition regarding exports and buy-back arrangements. Nevertheless, limited completely built units have been exported to countries such as Afghanistan, Bangladesh, Nigeria and Rwanda by two assemblers.

[10] Under these agreements, foreign firms provide local firms the expertise and technical support to manufacture components in Pakistan.

[11] Value added has been estimated on the basis of 18.5 per cent value added coefficient derived from the Census of Manufacturing Industries for 2000–2001.

[12] Exports of auto parts increased from $7 million in 1998–1999 to $31 million in 2002–2003.

[13] Besides import duties, a sales tax of 15 per cent on the duty-paid values is also imposed. Moreover, car and van owners have to pay capital value tax at the rates of 3.75 per cent for cars up to 1,000 cc, 6.25 per cent for cars from 1,000 to 1,500 cc and 7.5 per cent for all the other categories. These are applicable to imports as well as domestically-produced cars. The new assemblers are allowed import of 100 CBUs.

[14] For example, “Centro” had to start with 45 per cent deletion levels, but in a couple of years, it had to achieve the industry level deletion programme, which was 65 per cent. Similarly, in 2004–2005, the new assemblers in tractors were allowed at an initial deletion level of 40 per cent, but after two years they had to go up to 85 per cent.

[15] These deletion levels refer to the percentages of the value of parts produced in Pakistan as given in the ISDPs and that may deviate from the proportionate value of the parts if the entire kit was imported.

[16] The deleted parts themselves generally comprise assembly of the imported components.

V. Philippines

A. Introduction

The Philippines has a relatively long history of promoting the development of a national automotive industry through the use of TRIMs.[1] These TRIMs were instituted in the early l970s through policies requiring automotive investors to increasingly use locally-produced car parts and generate through exports a percentage of the foreign exchange needed to pay for imported automotive components. These twin policies were carried out until mid-2003, despite the prohibition by WTO, under the TRIMs Agreement. This chapter offers a historical inquiry into the role of TRIMs in the development of the Philippines auto industry.

The chapter is organized into four parts in addition to this introduction. Section B gives a general overview of the industrial shift from the import-substituting (ISI) to export-oriented (EOI) industrial strategies and the Government's campaign for FDI. Section C outlines the history of the automotive industry and the policy zigzags in the implementation of the localization program; Section D sums up the Philippine stand on the TRIMs phase-out, and Section E situates the Philippine car industry vis-à-vis the emerging Asian car market and the regional/global corporate strategies of Japanese and other transnational car makers.

B. ISI to EOI and the campaign for FDI

1. The rise of ISI industries

The Philippines has a long colonial past. During this period, the economy failed to develop, with industrial development limited to the initial processing of sugar, copra, hemp, tobacco and indigo for export. (In the 1930s, copper and gold entered into the trade picture.) In 1946, the country acquired political independence. However, the young republic was immediately hit by a deep politico-economic crisis engendered by a Communist-led insurgency, violent elections and the resumption of the colonial free-trade arrangement between the United States and a war-ravaged Philippines. The free-trade re-imposition resulted in a severe balance of payments crisis in 1949–50, forcing the State to adopt a series of measures to curb or regulate imports and preserve the nation's dwindling foreign exchange reserves. These measures eventually became permanent and were collectively dubbed the "import and foreign exchange controls".

Under the first Central Bank Governor, Miguel Cuaderno, these controls were used not only to prevent the entry of finished goods, but also to ration the limited foreign exchange reserves to "new and necessary" industries to cover their requirements for machinery, tools, industrial raw materials and other imported inputs. This paved the way for the rapid rise of ISIs based on light manufacturing and, along with this, the emergence of a nascent Filipino industrializing class. Table V.1 shows the rapid growth of the GNP in 1951–55, averaging 9 per cent. In the case of manufacturing, annual growth rates throughout the 1950s were in double digits – 14.5 per cent for 1949–1953 and 11 per cent for 1953–1957. These high growth rates have not been duplicated since.

The tremendous positive impact of the first decade of the ISI regime was summed up in a 1962 World Bank Report on the Philippines, which said:

> "*The major structural change since the war has been the growth of domestic manufacturing. Organized manufacturing (15 workers and over), which was limited to processing of agricultural products before the war, expanded more than 10 per cent per year during the 1950s. By 1960, it had become a significant segment of the economy, accounting for 12.7 per cent of the net domestic product that year.*

A vigorous entrepreneurial class has emerged and the nucleus of a skilled labour force has been formed..."

Table V.1. Average annual growth rates of GNP, 1946-2000

Years	GNP
1946–1950	17.2
1951–1955	9.3
1956–1960	5.0
1961–1965	5.5
1966–1970	4.8
1971–1975	6.5
1976–1980	6.3
1981–1985	-1.7
1986–1990	5.4
1991–1995	2.9
1996–2000	2.8

Source: NEDA statistical compilations.

Nonetheless, the first ISI decade did not resolve the balance of payments problem, as the industrial structure, based on light finishing and assembling industries, was heavily dependent on imported machines, tools and industrial raw materials. Thus, the crises recurred in 1959–1960.

The dilemma then was: where should the Philippines go? One choice was to go for export-oriented manufacturing, in order to correct the trade and payments deficits. Another was to deepen the industrial structure through the development of intermediate and basic industries, so as to lessen the dependence on industrial imports and increase industrial capacity. A third choice was to do both. Japan and, later, the Asian newly industrialized countries (NICs), did both, applying protectionism on both their domestic and export industries and consciously building up the depth and breadth of their industrial structures.

One of the first acts of then-President Diosdado Macapagal was to go to the International Monetary Fund (IMF) to borrow some $300 million to cover the country's payments deficits and provide added capital for future growth. But the price exacted by the IMF was stiff – the lifting of controls and the devaluation of the peso, from P2.00 to $1 to P3.50 to $1, ostensibly to discourage imports and promote exports. The devaluation, however, failed to correct the trade deficits and the economy remained overwhelmingly import dependent. When President Macapagal saw the deleterious effects of the peso devaluation on the local industrialists, he turned around and enforced a system of protection for the locals by erecting uniformly high tariff walls.

Although intended to protect the economy and local industry, the high-tariff regime had some negative repercussions. Firstly, it did not distinguish between the good and bad performers. All received protection. Second, there was no schedule announced for the eventual elimination of tariff protection. In short, the tariff regime was neither performance- nor time-bound.

Thus, throughout the 1960s, the economy grew but at a slower pace. More importantly, the trade and payments crises recurred in 1969–1970, forcing the Government to go back once more to the IMF, which, in turn, asked the Government to float the peso, leading to the devaluation of the peso to P6.50 to the dollar. Poverty, unemployment, and labour and social unrest swelled in the early 1970s.

2. The shift to EOI

When martial law was declared in 1972, the Government engineered a shift in economic orientation from the inward-looking ISI policy of the 1950s and 1960s to a more outward-looking export-oriented one. This shift was managed by a group of Western-educated technocrats and enjoyed the support of the World Bank, which set up with the IMF a Consultative Group of Creditor Countries for the Philippines (CGCCP). The EOI shift was originally baptized the labour-intensive export-oriented

industrial strategy (LIEO). The technocrats used the works of Gustav Ranis of Yale's Growth Center, Hla Myint of the Asian Development Bank and Hollis Chenery of the World Bank to justify the shift.[2]

The LIEO strategy was meant to both take advantage of the huge global market and to absorb excess labour. A leading role in the industrialization process was assigned to foreign capital and FDI enticed to invest in the newly-established export-processing zones (EPZs) or to register in the bonded warehousing manufacturing programme, which allowed duty-free importation for those engaged in re-export manufacturing. Finance capital provided by the multilateral and the bilateral agencies grouped under the CGCCP were meant to finance the cost of restructuring the economy to make it more efficient and outward looking. Thus, the EOI shift in the 1970s gave birth to new economic actors in the Philippines: (a) the international creditors (IMF, World Bank and Paris Club creditor members), (b) the Japanese,[3] who returned to the Philippines as investors and ODA givers, and (c) the TNCs engaged in production in the duty-free and tax-free location sites in EPZs.

The labour-intensive export-oriented programme had a modest impact on the economy, which grew in the 1970s through an infrastructure development binge financed by foreign borrowing. The country remained heavily import-dependent, with the new export-oriented garments industry engaged primarily in re-export manufacturing based on imported duty-free textiles and other materials. Thus, the trade and payments crises recurred in 1979–1980.

The World Bank came in and offered the Philippines a new lending facility – the structural adjustment lending programme. According to the World Bank, even if the official policy regime was LIEO, the economy failed to take off because it was not open or outward-looking enough. Hence, the adoption of the structural adjustment program (SAP) aimed at deepening:

- Trade liberalization via tariff reduction and phasing-out of import restrictions;
- Investment liberalization through laws eliminating equity restrictions;
- Privatization of government-owned corporations and assets (and later, services and public works); and
- Deregulation in various sectors, such as finance and agriculture.

Despite the collapse of the Marcos regime in 1986, the Aquino administration (1986–1992) continued with the SAP programme. It issued Proclamation No. 50 removing the legal and labour obstacles to the implementation of the privatization programme. It removed around 2,000 products from the pre-EOI list of restricted imports. It issued Executive Order No. 226 or the 1987 Omnibus Investments Code, which "simplified" the various investment facilitation measures and extended to non-export-oriented foreign investors some fiscal incentives. In 1991, the administration engineered in Congress a Foreign Investments Act (FIA), which allowed 100 per cent foreign equity even in non-pioneer undertakings in any area of the economy, except those listed in a "short negative list".

Under the Ramos administration (1992–1998), the SAP's economic liberalization programme was pursued even more relentlessly. The tariff reduction programme was accelerated under the Tariff Reform Program (TRP). Started in 1981, the TRP brought down tariffs to an average of 28 per cent in 1985; in 1993, tariffs went down to an average of 23.5 per cent; and in 1994, a third TRP established a tariff liberalization schedule aimed at bringing tariffs to a uniform 5 per cent by 2004. As of 2000, the average was already down to 7.96 per cent (see table V.2).

In spite of the 1997–1998 Asian financial crisis, the Estrada administration

(1998–2001) maintained the SAP programme, including its tariff and investment liberalization programmes. The Arroyo administration (2001–present) also continued it, which brought down tariffs for many industrial products at "nuisance" rates of 0–5 per cent in 2002-03 and for agricultural products at less than 10 per cent.

Table V.2. Average nominal tariffs by sectors and years
(%)

Year	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*
Agriculture	35.95	40.94	36.91	32.86	27.99	28.29	25.28	18.91	16.33	14.40
Manufacturing	24.61	23.21	21.46	17.62	13.96	13.37	11.38	9.36	8.98	6.91
Overall	25.94	25.55	23.50	19.72	15.87	15.55	13.43	10.69	9.98	7.96

Source: Tariff Commission.

Because of SAP and its unilateral tariff reduction programme through TRP, the Philippines had no problem complying with the requirements of the Association of South-East Asian Nations (ASEAN) Free Trade Agreement (AFTA), which was supposed to bring tariffs for ASEAN products to 0–5 per cent by 2003. Its MFN applied tariffs are nearly equal to the AFTA tariffs.

As for WTO, the Philippines simply bound its industrial and agricultural products to 10 per cent above its 1995 applied tariffs. However, WTO still has had a great impact because it caused the tarrification of agriculture (in 1996–1997), affected the shift in custom valuation (from home consumption to transaction valuation) and helped in the general consolidation of the liberalization orientation in economic policy.

3. Campaign for FDI

Before 1972, the main foreign investors in the Philippines were from the United States, whose firms were given "parity rights" as part of the 1946 handover agreement on Philippine independence. In manufacturing, most of the United States investments were in light assembly, e.g. electrical appliance and automotive makers assembling imported completely-knocked down (CKD) or semi-knocked down (SKD) parts to avoid the ISI restrictions against the importation of finished products.

When martial law was declared in September 1972 and LIEO was launched, the foreign investment environment became open to all foreign capital. Among the more important liberalization measures adopted were (a) the simplification of the tariff and custom code, with the export duties structured to promote manufactured and semi-processed exports; (b) creation of the Export Processing Zone Authority (EPZA); (c) rationalization of the Investment and Export Incentives Act through various presidential decrees; and (d) incentives for the establishment of regional or area headquarters of TNCs, and application for provisional membership to GATT. Martial law also provided "industrial peace" by banning strikes and concerted activities of workers from 1972 to the early 1980s.

Also, a new Constitution was introduced, which did away with the "nationalist" provisions of the 1935 charter. In mining, energy development and other extractive industries, the 1973 Constitution allowed the entry of foreign investors through a "service contract" provision.

As a result, the country witnessed a dramatic surge in FDI (see table V.3). By 1977, some 250 TNCs were present in the Philippines, half of which were engaged in

manufacturing. About 122 of them were from the United States and 96 were Japanese. In the EPZs, the Government allowed FDI to come in with 100 per cent foreign equity or through joint ventures. In non-EPZ enterprises, joint venture was the preferred government mode of enticing foreign investments, justified in the name of technology transfer. Joint ventures were usually on a 60–40 basis, with majority equity ownership held by Filipinos. The joint venture scheme was the main modality used in promoting the auto assembly industry, supplemented by a programme requiring investors to use locally-produced parts in increasing quantity (see section C).

Table V.3. Number of newly-registered domestic corporations with foreign equity (DCFEs), foreign corporations (FCs), regional headquarters of multinational corporations (RHMs) and representative offices (ROs), 1946–1977

Years	DCFE	FC	RHM*	RO
1946–1966	NA	510	NA	NA
1967	186	24	NA	NA
1968–1972	997	69	NA	NA
1973–1977	2,582	168	150	86
	3,579	791	150	86

Source: Mamoru Tsuda et al., *The Impact of TNCs in the Philippines: A Study of Major Foreign and Foreign-Affiliated Corporations in the Philippines*. UP Law Center, June 1978, t.1.

* Presidential Decree 218, promulgated in 1973, grants incentives to overseas corporations to establish their regional headquarters in the Philippines.

The succeeding Aquino, Ramos, Estrada and Arroyo administrations tried to deepen the investment liberalization programme in line with the SAP programme put in place in 1980–1981. The 1980s and 1990s also witnessed the proliferation of around 60 private industrial parks registered with the EPZA, mainly in Regions III (Central Luzon) and IV (Southern Tagalog) adjoining the National Capital Region (NCR) of Metro Manila. In the early 1990s, the Government transformed the former American military bases – Clark and Subic – into "special economic zones" (SEZs), which provide the same fiscal and duty-free privileges to investors-locators. Thus, with SAP and general investment liberalization, the Philippines was one of the most open economies in Asia by the mid-1990s. FDI fueled the growth of the "non-traditional" export sector, composed mainly of electronics and garments, which succeeded in replacing the colonial minerals and agricultural crops as the country's leading export products. Electronics, accounting for two thirds of total exports, is considered the Philippines' success story under the SAP.

During the super-liberalization decade of the 1990s, total exports quadrupled in eight years, from $8.8 billion in 1991 to $35.1 billion in 1999 (see table V.4). However, imports also tripled in only six years, from $12.1 billion in 1991 to $35.9 billion in 1997. Imports only went down in the Asian crisis years of 1997–2000, the years the country registered a modest trade surplus. From 1991 to 1997, the period when deep tariff cuts were made and most of the import restrictions were removed, the Philippine trade deficit ballooned from $3.2 billion to $10.7 billion.

Table V.4. Philippine trade 1990–2003
(billions of dollars)

Year	Total trade	Exports		Imports		Balance of trade
		Value	% total trade	Value	% total trade	
1990	20.4	8.2	40.1	12.2	59.9	-4.0
1991	20.9	8.8	42.3	12.1	57.7	-3.2
1992	24.3	9.8	40.3	14.5	59.7	-4.7
1993	29.0	11.4	39.3	17.6	60.7	-6.2
1994	34.8	13.5	38.7	21.3	61.3	-7.8
1995	44.0	17.4	39.7	26.6	60.3	-9.2
1996	53.0	20.5	38.8	32.5	61.2	-12.0
1997	61.1	25.2	41.2	35.9	58.8	-10.7
1998	**59.2**	**29.5**	**49.9**	**29.7**	**50.1**	**0.2**
1999	**65.8**	**35.1**	**53.2**	**30.7**	**46.8**	**4.4**
2000	**72.6**	**38.1**	**52.4**	**34.5**	**47.6**	**3.6**
2001	65.2	32.1	49.3	33.1	50.7	-1.0
2002	70.6	35.2	49.8	35.4	50.2	-0.2
2003	73.2	37.2	48.8	37.5	51.2	-1.8

Source: Economic Indices and Indicators, Division of Industry and Trade Statistics Department, National Statistics Office, 2 April 2004.

The reason for the surge in trade deficits can be gleaned in the composition of the country's exports and imports. The phenomenal export growth was accounted for mainly by one item – electronics, consisting of assembled semiconductor devices or chips and varied electronic parts or components. From $3.78 billion in 1993, electronics exports went up to $25.4 billion in 1999. On the import side, the most important items were telecom materials and electrical parts needed by the electronics industry. This is the basis for the observation that the value added in the industry is estimated to be between 10 and 20 per cent or even less. One study found that the local content "is in most cases less than 5 per cent" (Morisawa, 2000). For example, the local content is only 5–6 per cent at Texas Instruments Philippines, the country's biggest electronic exporter, and less than 1 per cent in the case of ROHM Electronics Philippines, Inc.

Outside electronics, the growth of other export products has been weak or marginal. In particular, garments, the country's leading exports in the 1980s, have been declining since 1995, when the value of garments exports reached $2.57 billion. This is due to the rise of cheaper production sites in Asia (China, Viet Nam, Bangladesh, etc.) and elsewhere (Eastern Europe, Caribbean, etc.) and the anticipation of the phasing-out of the Multi-Fibre Arrangement (MFA) under the WTO's Agreement on Textiles and Clothing (ATC). Garments have been overtaken by "machinery and transport equipment", which consists mainly of auto parts producers such as those making wire harnesses, anti-brake systems, transmissions, etc. Machinery and transport equipment increased its share of the total exports from 3 per cent in 1993 to 10 per cent in 1997 and 20 per cent in 2003.

4. Brief assessment of the EOI–SAP policy

Overall, the economy has not fared well under the EOI–SAP. As shown in table V.1, growth was highest during the ISI decades of the 1950s and the 1960s and lowest during the SAP decades of the 1980s and 1990s. FDI grew substantially in the 1970s to the 1990s (see table V.5). However, Malaysia, Thailand and China have been more successful in attracting FDI, which partly explains why these countries have bypassed the Philippines in economic growth terms. Even Viet Nam is lately attracting more FDI.

After three decades of EOI–SAP, the Philippines had failed to achieve industrial transformation. Dr. Josef Yap, now President of the Philippine Institute of Development Studies (PIDS), noted that mainstream economists have been in the driver's seat of economic governance for over a quarter of a century, and yet the country has failed to achieve industrial transformation. Table V.6 shows that the share of manufacturing to total Philippine output went down from 27.6 per cent in 1980 to 24.1 per cent in 2002, whereas those of Indonesia and Malaysia increased by 10 to 11 percentage points for the same period and that of Thailand by a remarkable 14 percentage points.

Table V.5. Comparative FDI, 1970–2003

Countries	Per capita income ($)	Total FDI inflow 1970-79 ($ billion)	Total FDI inflow 1980-89 ($ billion)	Total FDI inflow 1990-97 ($ billion)	Total FDI inflow 1998-2002 ($ billion)	2003 FDI inflow ($ billion)
China	923.07	0.00008	16.2	200.6	224.4	53.5
Indonesia	680.24	2.0	3.3	23.7	-12.4	-0.6
Malaysia	3 676.47	3.3	2.6	35.2	14.1	2.5
Philippines	911.88	0.8	2.1	8.4	7.4	0.32
Thailand	1 875.82	0.8	2.8	17.2	21.8	2.0
Viet Nam	413.84	0.008	0.1	10.1	7.0	1.45

Source: World Bank, World Development Indicators Database, 2004 and UNCTAD, Database 2004.

Note: Malaysia's 2000 FDI net inflows were $3.8 billion.

Table V.6. Share of manufacturing to total output
(%)

Year	Indonesia	Malaysia	Thailand	Philippines
1980	15.2	19.6	23.1	27.6
2002	26.6	30.0	37.1	24.1

Source: ADB key indicators, as cited Josef Yap, "A Generation of Economic Orthodoxy: Time to Take Stock", 21 September 2003, *Philippine Daily Star*.

There are many possible reasons for the lackluster performance of the economy under the EOI–SAP, both economic and political, which are beyond the scope of this paper. However, two explanations which are very much related to the automotive industry need to be highlighted here: neglect of promoting domestic capabilities and the lack of technology transfers from TNCs.

In Japan and the Asian NICs, including China today, export orientation was promoted alongside the system of domestic protection. These countries calibrated their liberalization measures based on the growing capacity of their domestic industries to survive and compete. Often, liberalization took place only after the industries had become globally competitive. In the case of the Philippines, however, the ISI industries were virtually neglected. They were not consulted on the schedule, pacing, sequencing and timing of the EOI–SAP liberalization programme. Philippine tariffs were reduced to rates way below other ASEAN and Asian neighbours. For example, Philippine tariffs are only a third of those of Thailand, both in industry and agriculture. Worse, the Government has been unable to clamp down on the operations of smugglers, who deprive the country of as much as P175 billion annually in foregone value added taxes and customs revenues, according to studies by the Federation of Philippine Industry, the Fair Trade Alliance and the Government's task force against smuggling. Finally, domestic industry is now bearing the full brunt of taxation since the free trade zones and industrial parks engaged in re-export manufacturing enjoy fiscal incentives while importers avoid paying taxes due to low tariffs and smuggling.

Another explanation is the unrealistic assumptions by the EOI–SAP proponents that FDI would fuel a spiral of industrial growth in the host country. The reality has been different. As demonstrated by the electronics assembly industry, what the TNC subcontractors transferred, after three decades of operations in the Philippines, is the technology of assembling semiconductor devices, electronic transistors and computer parts, or the technology of testing some processes. In the absence of any conscious or deliberate effort on the part of the host country to deepen forward and backward linkages, the foreign investors simply stuck to their limited development agenda in a limited market, as happened in the case of the local content programme for the auto industry.

C. TRIMs, economic deregulation and the local content programme collapse

1. Philippine car assembly and the local content programme

Before and after World War II, the Philippines imported CBUs of cars and other motor vehicles, mainly from the United States. But starting in 1951, CBU imports were banned, in line with the prohibition on the importation of finished products under the ISI programme. In 1952, CBUs were even reclassified from "non-essential consumers goods" (NEC category) to "unclassified or banned consumer goods" (UI category), meaning products with the lowest priority in the entitlement for dollar rations. The CBU ban paved the way for development of car, truck and motorcycle assembly industries, all of which engaged in the assembly of imported CKDs and SKDs, mainly from the United States. The new assembly plants were classified as "new and necessary industries", and given their share of dollar allocations. In turn, the assemblers used their foreign exchange allocations to import CKD/SKDs.

A Filipino company, Fabar Inc., was the first to go into the assembly business by venturing into the assembly of Austin and Studebaker cars. Later, the American pre-war car exporters – General Motors, Chrysler and Ford – established assembly plants. A number of enterprising Filipino industrialists also set up plants. By 1960, there were 12

assemblers. By 1968, this had increased to 29. Most were Filipino companies importing CKD/SKD packs from the United States, Europe and Japan. This number did not yet include Sarao and the numerous backyard makers of the "Philippine jeepney", a popular, colourful and rugged public utility vehicle in Manila and other cities.

Although the import and foreign exchange controls had been abolished in the early 1960s, the ban on CBUs virtually remained in place through the high tariffs erected by the Macapagal administration. Tariffs for cars were fixed at not less than 100 per cent.

Although limited and technologically underdeveloped, the Philippine car assembly industry was rated second only to Japan in East Asia up to the 1960s. A number of automotive engineers and workers from other parts of Asia used to visit Manila in the 1960s to study automotive assembly.

The idea of producing vehicles with more local content and less CKD/SKD inputs came from the Central Bank. As a result of the recurrence of the balance of payments crisis in 1968–1970 (which led to the peso "floating" devaluation), the Central Bank decided to restrict the allocation of foreign exchange reserves to CKD/SKD importers and suggested the "progressive" development of a vehicle manufacturing programme with increased local content.

However, some Filipino vehicle assemblers, after a decade of acquiring skills in assembly work, also openly expressed their ambitions to develop a "Filipino car". One of them, D.M. Guevarra, an assembler of Volkswagen cars, tried to produce a prototype of a Filipino car he dubbed as Sakbayan or Sasakyang Katutubong Bayan, which meant "original national vehicle". Guevarra also conceived of a similar product in the truck category, a Trakbayan or "truck of the nation".

In 1971, the newly-created Board of Investments (BOI) elaborated on the concept of developing a Filipino car through the Progressive Car Manufacturing Program (PCMP). It called for a ban on CBU imports and extended CKD import privileges only to those able to meet the Government's set targets on progressive increases in the local content of assembled cars and those able to generate foreign exchange earnings through the export of locally-made car parts or other "creditable" exports by the car makers. Officially, its thrusts were to develop a viable automotive component industry, promote small and medium-sized enterprises (SMEs) engaged in auto parts manufacturing and generate foreign exchange earnings through exports of automotive components to other Asian countries.

However, the programme took off only in 1973. Aside from the PCMP, the Government also launched a Progressive Truck Manufacturing Program (PTMP) and Progressive Motorcycle Manufacturing Programme (PMMP). The original target of the PCMP was an increase in the domestic content from 15 per cent in the first year, 25 per cent in the second year and 35 per cent in the third year, progressively increasing thereafter. Aside from saving foreign exchange in terms of increased parts manufacture, the programme sought to build up exports based on a regional automotive complementation programme in the context of the newly-organized ASEAN.

To ensure its success, the programme limited the number of participants to only five joint venture assemblers. There were seven applicants to the PCMP programme, but only five were selected: Delta Motor Corporation (Toyota), Ford Philippines Inc., Canlubang Automotive Resources Corporation/PAMCOR (Mitsubishi), Franciso/Yutivo/General Motors Philippines and DMG, Incorporated/Nissan Motors Philippines.

Because the PCMP participants were the only ones allowed to import CKDs, the non-PCMP assemblers either closed down or tried to survive by merging with the PCMP participants or by doing subcontracting work for them. The CKD imports were allowed on the condition that these imports were partly paid through the foreign exchange earnings generated by exports made by PCMP participants. Since PCMP participants were not in the business of assembling cars for export, they set up related car-part production businesses such as the manufacture or assembly of transmissions, diesel engines and other critical auto parts exported to other Asian countries, usually subsidiary assemblers of the transnational car makers.

The PCMP took off auspiciously in 1974, with foreign investors putting up $84.3 million (see table V.7). A number of car-part makers mushroomed, with the PCMP participants themselves leading the way.

PAMCOR, through its affiliate, Asian Transmission Corporation (ATC), set up an engine transmission manufacturing plant in Calamba, Laguna. The engine transmissions and related transmission components (such as rough forgings and castings) were marketed to the local PAMCOR's assembly plant and to Mitsubishi Japan and other Mitsubishi subsidiaries in Asia. Delta Motor established an automotive engine plant producing engine assemblies fitted with Delta-manufactured engine packs, cylinder heads and bearing caps, as well as clutch housings for other PCMP participants. DMG invested on press-forming facilities to produce varied engine parts and stamped and pressed steel body components for its "Sakbayan" passenger cars. Partial machining of the Volkswagen engine was also undertaken. Ford incorporated Ford Ensite Limited, a car body stamping company based at the Bataan Export Processing Zone. The plant manufactured Cortina sheet metal body stampings and sub-assemblies for export to Ford's affiliates in the Asia-Pacific region, with Ford Australia as the lead market. The plant was capable of producing over 80 different body stampings, including roof and wheelhouse panels. General Motors ventured into the manufacture of engine transmissions, which were exported to Australia, New Zealand and other Asian countries.

Table V.7. Foreign investments in the Philippine car market, 1974-1994
(Millions of dollars)

Year	*Investments*
1974	84.3
1975	45.2
1976	31.2
1977	35.6
1978	22.5
1979	23.4
1980	21.8
1981	24.0
1982	21.7
1983	11.4
1984	6.6
1985	10.5
1986	5.0
1987	3.6
1988	2.6
1989	7.0
1990	6.4
1991	6.5
1992	6.8
1993	7.3
1994	8.0

Source: CRC research unit.

Independent Filipino car-part producers, with licenses or in joint ventures with the big car makers, concentrated on less sophisticated car parts such as mufflers, floor carpets, horns, silencers, etc. The local parts generated by PCMP included engine support, accelerators, clutch pedals, fan belts, axle boots, headlights, coil/leaf springs, glass, seat assemblies, seat frames and adjusters, harnesses, wheels, tires, batteries, pipes and tubes, rubber hoses, radiators, door trims, brake drums/discs, fuel tanks, air conditioners, car stereos, speakers, rubber bumpers, shock absorbers, trunk trims, shelf trims and weather strips.

There were 32 car-part makers in 1974; by the end of the 1970s, there were more than 200. In the 1980s, over 250 car-

part makers had registered with the BOI. Moreover, there were unregistered backyards or small car parts producers doing contracting work for the bigger part makers. All the PCMP, PTMP and PMMP participants claimed they were able to attain a 40 per cent local content – the minimum requirement – in the second half of the 1970s. This was difficult to verify, especially for the PTMP participants.

In the case of the motorcycle assembly, the PMMP participants proudly claimed to have attained over 50 per cent local content, which is understandable given the lower technological makeup of motorcycle production. The PMMP participants included Norkis, a licensee of Yamaha and a 100 per cent Filipino firm. The others were joint ventures with Kawasaki, Honda and Suzuki, all Japanese motorcycle makers. Table V.8 shows the localization success in the motorcycle assembly. The localization success was partly fueled by the domestic market growth for motorcycles, especially for the three-wheeled ones (or "tricycles") which are extremely popular as public conveyances in many towns and side streets of metropolitan Manila.

Table V.8. PMMP local content and sales

Year	Local content (%)		Sales (No. of units)
	Prescribed	Attained	
1973	10	21	19 796
1974	20	22	29 075
1975	30	33	29 456
1976	40	45	31 028
1977	50	46	42 188
1978	50	52	51 769
1979	50	54	49 059
1980	50	55	44 774

Source: Virginia Pineda, *Motorcycle and Parts Industry*, PIDS (1994).

As to the progressive truck manufacturing program (PTMP), the Government had been sparing in reporting, ostensibly due to the limited assembly work in the bigger vehicles such as buses and trucks, most of which were imported in CBU forms. However, there is great localization success in the production of commercial vehicles called the Asian utility vehicles (AUVs), which are ideal as family vehicles or all-round vehicles for small enterprises.

Despite its success in the 1970s, the PCMP programme collapsed in the first half of the 1980s. Problems started in 1979–1980, during the second oil shock, which depressed the car and vehicle market. The Philippine car market got further depressed in 1980–1986, due to the political crisis of the Marcos regime; and the debt crisis in 1983–1985, which precipitated an economic recession and uncertainties over the future of the country.

In 1983–1985, the debt crisis became a letter-of-credit crisis, meaning importers had to deal with the outside world on a cash basis. This greatly affected the operations of CKD importers and local parts assemblers, who also had to deal with a fast-shrinking market. This was the period when three of the five PCMP participants dropped out. Ford and General Motors closed its operations and justified this as part of their global streamlining programme. Delta Motors, assembler of Toyota cars, had to mothball its facilities because of massive indebtedness triggered by the peso devaluation and the depressed market.

As indicated in table V.7, FDI dramatically declined from the mid-1980s to the first half of the 1990s. During the crisis years of the 1980s, the Government was virtually unable to monitor and enforce the local content programme for the original PCMP, PTMP and PMMP participants.

2. CDP and the automotive liberalization/deregulation programme

In 1987, the Aquino administration tried to revive the PCMP. It was re-baptized the Car Development Programme (CDP), but with essentially the same implementation elements – a ban on CBUs, local content targets and foreign exchange earnings through exports. CDP covered passenger cars with engine displacement of up to 2,800

cubic centimeters. The CDP participants were limited to three – PAMCOR, Nissan Philippines and Toyota Motors Philippines (which took over the idle facilities of Delta Motors). Local content levels were set as follows: 32.26 per cent for 1988, 36.58 per cent for 1989 and 40 per cent for 1990.

The CDP participants were also asked to generate 50 per cent of their foreign exchange requirements through their own exports, with the auto parts exports accounting for the entire 50 per cent by 1993. Further, the CDP participants were required to invest in the development of at least one major auto component that would account for at least 9 per cent of the net local content.

At about the same time and together with the CDP, the Commercial Vehicle Development Program (CVDP) was launched to replace the Progressive Truck Manufacturing Programme. Like the CDP, the CVDP increased the 1990 local content targets – ranging from 13.7 per cent to 54.8 per cent for various categories of vehicles. The CVDP also required producers to earn at least 25 per cent of their foreign exchange requirements through exports.

In the motorcycle assembly, the PMMP was replaced by the Motorcycle Development Programme (MDP). The local content target for MDP producers was 55 per cent by 1990. As in the 1970s, this was easily exceeded by the MDP participants, given the lighter nature of the industry.

In 1990, the CDP was amended to include the assembly of smaller cars called "people's car", with an initial price ceiling of P175,000. New car assemblers joined the "people's car programme", including Honda Motors, Columbian Autocar (to assemble Kia), Transfarm (Norkis Gurkel), Italcar Philipinas (Fiat) and Asian Carmakers (Daihatsu). Participation in the programme meant eligibility for inclusion in the CDP proper, at the higher engine category, after a while. Thus, by 1990, there were officially eight car assemblers and 26 commercial vehicle assemblers.

In 1992, the CDP was further amended, this time to allow the assembly of high-end passenger cars with engine displacement greater than 2800 cc. This allowed the entry of Volvo International (Sweden) and Daimler Benz (Germany).

Finally, in 1994, the CDP was amended to allow the entry of new assemblers under the ASEAN Industrial Joint Venture (AIJV) scheme. A joint venture with Proton of Malaysia was set up but never took off. Officially, the number of the CDP participants had reached 11 by 1994, from the original three in 1987.

The reality, however, was that the CDP had become meaningless in 1991, with the passage of the Foreign Investments Act, which allowed 100 per cent foreign investment in all activities not falling under the "short negative list".

In the meantime, as part of the general Philippine commitment to SAP, tariffs for cars had been going down. It should be recalled that CBU imports were banned in the first ISI decade. This ban was subsequently replaced by a high tariff of 100 per cent, and even higher tariffs for luxury vehicles. In the 1980s, the tariffs started to decline, as part of the general Philippine commitment to the SAP. Thus, in 1981, tariffs on cars went down to 70 per cent, to 50 per cent in 1982 and to 40 per cent in 1993.

However, tariff rates for CKD imports went down even faster. They averaged 30 per cent in the 1980s, dropped to 20 per cent in 1993–1994 and 10 per cent in 1995 before reaching only 3 per cent in 1996–1997. These CBU and CKD tariffs were the lowest among all the ASEAN car producers.

The tariff reduction programme, which had been applied more aggressively on the car parts and components, meant that the local assembly of cars was protected while the local part and component producers were not (table V.9). Table V.10 compares the low Philippine tariffs with those of its ASEAN neighbours.

In February 1996, the Government issued Memorandum Order No. 346, which liberalized the importation of CBUs or all types of passenger cars, commercial vehicles and motorcyles – subject, of course, to tariffs, which had been cascading down. An immediate impact of this policy was the entry of new car models and the decline in car prices, to the delight of consumers.

Table V.9. MFN tariff rates for motor vehicles and parts (2001)

Imported Items	Motor Vehicles	Duty (%)
CKD	Passenger car	10
	Commercial vehicles:	
	Buses	3
	Trucks	3
	Motorcycles	3
Selected auto parts	Engine	3–10
	Body stamping	3–10
	Transmission	3–10
CBU	Passenger car	30
	Commercial vehicles	
	Buses	15–20
	Trucks	30

Source: Tariff Commission.

Table V.10. MFN vehicle tariff rates of ASEAN countries
(%, in 2002)

Products	Malaysia	Thailand	Indonesia	Philippines
CKD				
Cars	42–80	33	35–50	10
CV	Nil	20–33	0–25	3
CBU				
Cars	140–300	80	45–80	30
CV	30–50	40–60	40–45	20–30

Source: DTI motor vehicle product team, 2002.

Nevertheless, the established car assemblers were able to overcome the more competitive economic environment through a higher volume of production, as 1995–1996 were "boom" years for the economy and the automotive market.

3. The crisis of the automotive industry, 1997-98 to present

Most of the liberalization/deregulation measures affecting the industry were imposed in the mid-1990s, when the economy was booming and the car market expanding. Annual passenger cars sold in 1991 almost trebled from 28,000 to 80,000 in 1996; light commercial vehicles more than doubled, from 24,000 to 59,000.

Box V.1. Deregulation/liberalization of the automotive industry as of 1996

1. ***Tariff and import regulations***
   Ban on CBUs lifted
   Reduction of import tariffs: 40% on finished cars
   3% on CKD parts
   5% flat tariff targeted for 2004

2. ***Regulations on automotive assembly business***
   Restriction on industry participation lifted
   Restriction on number of models and variants assembled abolished

3. ***Local content regulations***
   Passenger cars – local content of 40% retained
   Commercial vehicles (vans and light vehicles only) – local content of 45 % retained
   Local content requirement to be abolished by 2000

4. ***Forex requirement regulations***
   Passengers cars – 5 to 75 per cent ratios, depending on vehicle categories
   Commercial vehicles – 5 to 15% ratios, depending on categories
   Forex requirement to be abolished by 2000.

Thus, even if the system of protection under the original PCMP/CDP was being dismantled, the registered car assemblers did not register any strong opposition to the liberalization/deregulation programme. Moreover, the assemblers helped themselves

by also importing CBUs of various models and sourcing cheaper and quality CKD packages produced by their sister companies in other countries.

However, in the late 1990s, the industry was back in crisis. The Asian financial contagion drastically affected the market (see table V.11). Thousands of workers were laid off with the closure of a number of parts manufacturers and the downsizing operations by all car assemblers. The 20 or so assemblers of Japanese, Korean and European vehicles had to reduce capacity between 20 per cent to 50 per cent or more.

Table V.11. RP total vehicle sales (domestic) (1995-1999)

Year	Passenger cars	Commercial vehicles
1995	65 808	53 392
1996	79 673	58 815
1997	69 070	51 418
1998	32 134	35 769
1999	25 130	39 505

Source: CAMPI.

Despite the recovery of the Asian and Philippine economy from the 1997–1998 regional financial crisis, the local assembly industry had been operating below capacity, estimated by local informants as only 40 per cent capacity up to the present. One reason was the flood of imported brand new vehicles and parts.

With declining tariffs and a general perception that imported vehicles and auto parts were better in quality than locally-produced ones, imported brand new vehicles and CKD packages began hurting and displacing the local producers, eroding the "progressive" intent of the CDP. Hence, the campaign was launched among the assemblers for the upward recalibration of the tariffs. Subsequently, the Government raised in 1998 the tariffs for CKD packages to 7 per cent and to 10 per cent in 1999. These rates were still low compared to other Asian producers, most of which were hovering at 30 per cent or higher.

In 2003–2004, the Government imposed new "excise taxes", which did not distinguish between the locally-assembled and the imported vehicles. This was partly a response to the pressure of the IMF for a shift from taxation based on engine displacement to one based on values. Thus, all vehicles, locally-assembled and imported, were now uniformly taxed based on value.

In terms of value, those at the low-end bantam category were given a very low 2 per cent tax based on the argument that such cars should be affordable to the rising middle class. But most of these bantam cars are not assembled in the Philippines due to economy of scale limitations. Most of them are imported from the other Asian countries, principally Thailand. With the AFTA intraregional tariff rate of 5 per cent and the low excise taxes, it became profitable for some assemblers and importers to resort to importation of such cars.

One major victim of this "reform" was the Philippine production of the Asian utility vehicles (AUVs), which were classified under the low-end category of commercial vehicles. The AUVs were products of earlier ASEAN industrial complementation schemes, which were developed in the 1970s and 1980s. In the 1990s, these AUVs, which enjoyed fiscal incentives, experienced a sales boom. With 8-10 seats and new stylish designs, they became "hot" items for big Filipino families, small family enterprises and operators of the new "mega" taxis, which bring white-collar commuters to their places of work or at home along specified routes. By the second half of the 1990s, more than half of the locally-assembled vehicles were accounted for by the AUVs. Moreover, the local contents of Toyota's Revo, Mitsubishi's Adventure, Honda's CRV and Isuzu's Crosswind reached 50 per cent or more. Isuzu even claimed that the popular Crosswind was essentially a

product of the ingenuity of Filipino engineers and designers.

In 2003–2004, the Automotive Industry Workers Alliance (AIWA), unions in the major vehicle assembly companies, launched a campaign against the proposed excise taxation, which they feared would adversely affect jobs in the shrinking assembly industry. AIWA failed to block the measure. In mid-2004, the fiscal incentives for AUVs were removed and were replaced with excise taxes of over 20 per cent. Since then, the market for AUVs has slowed, with Toyota deciding to phase out its Revo in favor of Innova, while others are mulling similar adjustments.

The biggest threat to the local assemblers was not coming from the importation of brand new vehicles and parts, facilitated by the twin programmes of import liberalization and tariff reduction. It came from imports of second-hand vehicles (of all types and sizes) and "surplus parts" (in reality second-hand parts), coming mainly from Japan, the Republic of Korea and Taiwan Province of China. These vehicles and parts, priced at virtually giveaway prices, captured the imagination of the middle and lower classes. Records of the Land Transportation Office indicate that over 200,000 "new" vehicles have been registered nationwide, and yet the local assemblers are able to account for less than 100,000 in the aggregate (see table V.12). This suggests that almost half of "new" vehicles are imported second-hand.

In response, local assemblers launched a campaign against the second-hand imports and the leniency of the Government in allowing the massive entry of the imports. The campaign was anchored on environmental grounds, safety grounds, employment grounds and industrialization grounds. Additionally, the Philippines appears to be the only East Asian country allowing the massive entry of second-hand vehicles.

Table V.12. Newly-registered vehicles (cars and commercial vehicles), 2000–2003

	2000	2001	2002	2003
Locally-assembled	83,994	76,671	85,594	92,336
Others	88,057	97,023	113,336	103,228
Total	**172,051**	**173,694**	**198,930**	**195,564**

Source: CAMPI.

One impact of the flood of imported CKD packages and "surplus" parts was the closure or inactivity of local producers. Although there are 250 or so registered car-parts makers, according to the BOI, the active ones have dwindled to less than 100, with many operating below capacity. In contrast, Thailand has over 1,000 active car-part makers today.

D. Political responses to the TRIMs phase-out

In the context of the above outline of the policies on the local content programme, the investment liberalization, the deregulation of the car and car parts market in the second half of the 1990s, and the import liberalization for brand new and second-hands vehicles and parts, it was surprising that the Philippines availed itself of the transition period to phase out the local content programme for the car assembly under article 5 of the TRIMs Agreement.[4]

In seeking for the TRIMs' extension, the Philippines aligned itself with its ASEAN neighbors – Thailand, Malaysia and Indonesia – which all asked for the same extension. But in 1995–1996, Thailand had already become a regional automotive hub, Malaysia's Proton programme was being institutionalized and Indonesia had just announced its "national car" project. The Philippines was then putting the finishing touches for its vehicle liberalization/ deregulation programme.

1. The Senate stand

The Philippine Senate, in the "Report of the Committee on the Whole on the General Agreement on Tariffs and Trade" (1994), which was used as the basis of the Senate ratification of Philippine membership in the newly-formed WTO, noted that the TRIMs' prohibitions on local content regulations, export requirements and other forms of trade-balancing requirements as a precondition for the entry of investments "are rendered non-issue by the passage of RA 7042 or Foreign Investment Act (FIA) in June 1991", which "relaxed the country's foreign investment regulations by allowing foreign equity participation up to 100 per cent in all areas not specified in the negative list".

Expressing the sense of the pro-GATT majority among the Senators, the report stated: "to be competitive, industry should be free to procure inputs from the cheapest and most reliable source", meaning at home or in the global market. The report observed that the Philippines had earlier abandoned the local content programmes for trucks, consumer electronics and diesel engines, which were never pursued seriously by the Government,[5] and had plans to give up the local content programmes for cars and motorcycles. As to the promotion of exports, the Senate report stressed that export incentives were still available to local and foreign investors under the country's export promotion drive. Three Senators, out of 23, expressed dissent to the report.

2. End of the local content programme

In October 1999, before the lapse of the five-year transition period on 1 January 2000, the Philippine Government requested another five-year extension of the transition period, arguing that the Philippines had not yet recovered from the Asian financial crisis of 1997–1998. The only objection to the three-year extension request by the Philippines came, strangely, from the United States. As a leading donor country of the country, it should be most familiar with the economic liberalization programme in place in the Philippines. The objection was based on the argument that local content requirements are a violation of free trade principles. After some bilateral consultations, in November 2001, the United States and the Philippines came to an agreement for the Philippines to phase out immediately its foreign exchange balancing requirements and to remove all local content requirements by 1 July 2003. This agreement became the basis of the WTO approval of the extension until end of June 2003.

A possible reason for the American objection was to seek an assurance that the "playing field" for investment in the automotive assembly industry would remain equal. The vehicle assembly industry had become a Japanese vehicle assembly industry because of the withdrawal of Ford and General Motors in the early 1980s. United States car makers apparently had some plans to revive their assembly business in the Philippines. While General Motors decided to set up their South-east Asian hub in Thailand, Ford saw the Philippines as a platform to export some Ford brands in Asia. In fact, in 1997–1998, Ford decided to invest in an assembly plant in Laguna, Philippines, for the production of some brands for local distribution and export to neighboring Asian countries.

In July 2003, the Philippine local content programme for vehicle production officially lapsed. There were no efforts at all, from any quarter of the industry, to extend it further.[6] As to its implementation during 1995–2003 , DTI-BITR and the BOI officials noted that their offices had no control over the programme; their task was only to notify WTO and ensure a smooth transition in its phasing out.

Overall, the Government's tariff reduction programme, investment liberalization, subsequent 1997–1998 Asian financial crisis (which reduced the market for cars by more than half) and the liberalization of vehicle and parts imports (brand new and second-hand) literally phased out the programme. In fact, the TRIMs' extensions were not accompanied by any measures seeking to increase the local content.

3. Auto workers' campaign against liberalization/deregulation

Given the shrinking car market in a liberalized and globalized environment, the automotive workers, mostly from the car assembly industry, started taking up the issue of tariff reduction. Since 2000, AIWA, with some support from the industry, had been agitating for a postponement of the reduced tariff rates for the car industry under AFTA and WTO.

AIWA is an alliance of trade unions in the car assembly industry, all of which suffered during the painful restructuring of the industry in 1997–1998. A number of car assemblers either closed shop, such as Hyundai, or temporarily shut down, such as Nissan. Mitsubishi was hit by a one-month strike, after it had laid off nearly a third of its workforce. In the other car assembly plants, such as Honda, strikes were only prevented because the Secretary of Labour assumed jurisdiction over their disputes. Many car-part makers, including big export-oriented ones, such as UE Tech, went out of business. Overall, the car assembly industry recorded over 3,000 job losses in 1997–1999, and the auto-parts industry over 4,000 losses.

Thus, with the scheduled further trade liberalization in the industry in 2001–2004, the AIWA affiliates saw bleaker prospects on the horizon – hence, their decision to forge an alliance and to force the Department of Labour and Employment to set up a Tripartite Industry Council for the Automotive Industry. Indeed, in January 2003, under AFTA, tariff rates for CBUs went down to as low as 5 per cent. In January 2004, under the Philippine commitment to WTO, MFN tariff rates were reduced to 5 per cent. It was not clear to the leaders and members of AIWA how the car assembly industry and their jobs would survive under the liberalized regime. Their anxieties were further aggravated by the failure of their principals, mainly their Japanese car employers, to disclose the overall plans of the Japanese car makers under AFTA and WTO.

However, official spokesmen for the car assembly industry have been articulating the need for the maintenance of protective auto tariff rates up to 2005 and beyond. For example, the Philippine tariff rate in 2002 was 30 per cent, compared to Thailand's 80 per cent, Indonesia's 45-80 per cent and Malaysia's 140–300 per cent.

Despite the deep downsizings and massive retrenchments that hit the industry in 1997–1999 as a result of the Asian financial crisis, layoffs in the industry appear to be continuing (see table V.13). AIWA laments: "In the 1960s, we were second to Japan in Asia in the vehicle assembly. In the 1970s, we were overtaken by the Republic of Korea; in the 1980s, by Malaysia; and in the 1990s, by Indonesia and Thailand. Today, Viet Nam might overtake us."

Table V.13. Layoffs in automotive industry by establishment and displaced workers 1999-2002

Year	Establishment		Displaced workers	
	Closure	Reduction of workforce	Closure	Reduction of workforce
1999	0	15	234	224
2000	7	10	784	274
2001	4	15	492	502
2002	5	26	79	596

Source: Yearbook of Labor Statistics 1999–2002.
Note: Classification of the industry into minor industries was implemented only in 1999. From 1990 to 1998, classification is by major industry.

In 2003, AIWA extended its advocacy for the protection of the car assembly industry by denouncing the new excise tax on motor vehicles. According to AIWA, the tax rationalization program was "irrational" because it imposed a measly 2 per cent tax on the cheapest-selling cars, most of which were imported, and radical tax increases of close to 20 per cent for the AUVs, which were assembled locally.

E. Philippine car assembly and car parts production in a changing Asian and global car market

The plan to have a Filipino car by the end of the 20th century, with 80 per cent or so local content started with the wrong gears. It was assumed that TNCs, mainly the emergent Japanese car makers, would transfer the technology on an increasing rate via joint ventures and rules on local content and foreign exchange earnings.

This was not exactly how the Japanese and other car makers viewed the programme when they invested in the Philippines and joined the PCMP and CDP (and PTMP/CVDP and PMMP/MDP). At the beginning, their plan was to penetrate the Philippine domestic market, which, under ISI and later PCMP, was protected by the CBU ban and high tariff walls. The only major modification to the programme was the transformation of the Philippines as a production hub of select auto parts destined for the global market such as wire harness and transmission.

However, despite liberalization/ deregulation and the phasing-out of local content and foreign exchange requirements, the local car assembly industry and auto parts manufacturing industry are not about to collapse or disappear.

Firstly, there will always be a demand for vehicles in the Philippines; even a demand for just over 100,000 units a year is considered low in the South-east Asian region. Such a demand will always require that some assembly work be done locally. Secondly and more importantly, the car industry is heavily regionalized and internationalized. Japanese car makers will continue to maintain or even expand their investments in the Philippines as part of their regional and global operations. In fact, the Philippines, in the 21st century, is now an exporter of CBUs in the region! Ford Philippines started it, and Japanese car makers are now slowly doing the same, deciding on which car models to assemble for export and which to import. However, the volume of CBU exports is much smaller than the CBU imports.

1. The changing Asian strategies of Japanese and other car makers

In the 1970s and 1980s, when the Japanese began relocating car assembly and parts production facilities offshore, the idea was to avoid the prohibitive cost of labour in Japan and develop the car markets in the emerging economies of Asia.

In particular, in the 1980s, following the revaluation of the yen as a result of the Plaza Accord of 1985, some $15 billion of Japanese FDI was ploughed into South-east Asia (Bello et al., 2004). Unfortunately for the Philippines, Japanese TNCs found Thailand a more attractive location, with its booming market and better infrastructure. Thailand became the South-east Asian car hub of Japanese companies, a platform for the assembly and export of popular brands such as Toyota Alti or Mitsubishi Lancer to other Asian countries and to North America.

However, the Japanese companies took care that they set up assembly plants in the different South-east Asian countries, given the high tariffs and various forms of protection that had been erected. They also brought in, either wholly or in joint venture, facilities for the production of auto parts,

with different Asian countries specializing on certain parts. It is in this context that the Philippines became a major production base for Mitsubishi and Toyota transmissions.

There have recently been strategic adjustments in the Asian car programmes of the Japanese and returning American and European car makers. With tariffs in ASEAN down to 5 per cent, the region of over 500 million people has become attractive as a market and is increasingly treated as one market – for CBUs assembled in one country. Thus, some Japanese car makers are consolidating the production of popular brands in Thailand, while allocating one or two exportable brands to each of the ASEAN countries based on capacities and market demands.

The process was aided by the decision in 1996 by ASEAN to have an ASEAN Industrial Cooperation (AICO) scheme, which grants preferential tariffs of 0–5 per cent for companies with subsidiaries in two or more ASEAN countries. The purpose of AICO is to promote a regional division of labour for the production of parts and final products. Accordingly, an AICO product must have at least 40 per cent ASEAN local content. To date, most of the AICO participants are Japanese car makers (see table V.14). In fact, in the Philippine list of AICO companies, only 5 of 31 registered in 1999–2002 are non-auto-related.

Table V.14. List of Philippine AICO projects, 1999-2002

Philippines	Co-participating countries	Products
Auto-related		
Phil Auto Components	Denso Thailand	Instrument clusters, dial, bulbs
Honda Cars Philippines	Malaysia Oriental and Honda Cars Thailand Malaysia Assembly and	CKD for OEM of Honda Accord, City and Civic CKD for OEM of Toyota Utility Vehicle and Corolla
Toyota Motor Philippines	Toyota Thailand	CKD for OEM of Hi-lander
Isuzu Philippines	Isuzu Thailand	Clutch assembly, bracket, rotor assembly, vacuum pump
Laguna Auto-Parts	Indonesia Lippo and Thai Mitsubishi Electric	CKD for OEM of L-200 and Lancer
Mitsubishi Motors Phil	Thailand MMC Sittipol	Parts and CKD for OEM of TUV, Corolla, Camry, transmission
Toyota Motor Phil and Toyota Autoparts Phil	Toyota (of Indonesia, Malaysia and Thailand)	CKD for OEM of Lynx and pick-ups
Ford Motor Philippines	Auto Alliance Thailand	
Honda Cars Philippines	Indonesia Honda Prospect, Malaysia Honda Autoparts	Parts for OEM of Civic, City and Accord Parts for OEM of Sentra, Sunny and pick-ups
Nissan Motor Philippines	Siam Nissan, Malaysian Tan Chong & Son	CKD for OEM of L200, L300 and Adventure/Kuda
Mitsubishi Motor Phil	Indonesia Krama Yudha	
Toyota Motor Philippines	Indonesia Toyota Astra, Malaysia Assembly, Siam Toyota	CKD for OEM for Corolla, Camry
Autobus Industries	Thailand Arvin Exhaust	Exhaust system parts
Honda Cars Philippines	Thailand Honda, Malaysian Assembly/Honda Parts	Parts for OEM of Honda cars
Mitsuba Mfg. Ltd.	Thai Summit Mitsuba	Parts for wiper assembly
Nissan Motor Philippines	Malaysia Tan Chong, Siam Nissan	Parts for OEM of Nissan
Toyota Motor Philippines	Indonesia Toyota Astra, Malaysia Assembly, Siam Toyota	CKD for OEM of Corolla
Honda Cars Philippines	Indonesia Honda Prospect, Thailand Honda	Parts for Civic, Accord
Ford Motor Co. Phil	Thailand Auto Alliance	Parts for OEM of Escape, AUV
Honda Cars Philippines	Indonesia Honda Prospect, Malaysia Assembly, Thailand Honda	Parts for OEM of CRV
Toyota Motor Philippines	Malaysia Assembly, Thailand Toyota	Parts for OEM of Camry and Corolla
Honda Cars Philippines	Indonesia Honda Prospect, Thailand Honda	Parts for OEM of CRV
Phil Auto Components	Denso Thailand	Evaporators, radiator tanks
Honda Cars Philippines	Indonesia Honda Prospect, Thailand Honda	Parts for OEM of Civic, CRV
Toyota Motor Philippines and Toyota Autoparts	Malaysia Assembly, Thailand Toyota	Parts for OEM of TUV, Camry, Corolla
Honda Cars Philippines	Honda (Thailand, Malaysia, Indonesia)	Parts for OEM of Civic, CRV
Non-auto		
Matsushita Electric	Indonesia National, Matsushita (Malaysia, Thailand)	Electric fans and parts
Goya Inc.	Nestle (Indonesia, Thailand), Malaysia Packaging	Cocoa blend, skimmed milk powder, laminates, wrappers
Republic Asahi Glass	Thailand Safety Glass	Glass for motor, kitchen
Goya Philippines	Nestle Indonesia	Packaging materials, confectionary products
Bataan Polyethelyne	Malaysia Polyethelyne, Indonesia Petrokimia	Different grades of HDPE and LLDPE

Source: Philippine Tariff Commission.

However, with the AFTA programme now in place, the global car makers have greater incentives to form their own regional divisions of labour in the ASEAN region and assign what models and parts to produce in each country. They do not even have to register under the AICO programme, as any importer-exporter within the ASEAN region, with 40 per cent ASEAN local content, can do business within the region. Thus, Ford, which returned to the Philippines in 1997, is now using the country as a production platform to export Ford Focus, Mazda Tribute and Mazda 3 to other ASEAN countries. However, it is also investing in other ASEAN countries in the assembly of certain other models and in parts production.

For the Philippines, one problem is that, with one of the lowest car sales in the region, it can neither be a car hub nor a producer of the most popular exportable Japanese cars.

2. Rise of global parts producers and crisis of domestic-oriented car parts makers

The Philippines, however, can be a major producer of, if not a production hub for, select car parts. To keep production of these parts at a high productive level, the Japanese principals are even conducting "organized competition" among similar producers of the same car parts in the different Asian countries. This is why several Asian countries seem to be producing similar parts organized by the same Japanese car makers.

The Philippines managed to acquire a reputation as a major source of world-class car parts. Despite the general underdevelopment of its car-part industry and the dwindling number of car-parts makers, the country now hosts huge factories producing car parts that are exported not only in Asia but globally.[7] There are also Philippine-based exporters of gear boxes, tires (Yokohama), filters, silencers, aluminium wheels, plastic grills and rubber hoses. The only exception is a 100 per cent Filipino firm, Ramcar, which is able to penetrate the world market with its world-class car batteries. Table V.15 shows the rising figures for exports of auto parts and components from the Philippines.

Table V.15. Exports of auto parts and components, 1991-2000
(Millions of dollars)

Year	Value of exports*
1991	228
1992	362
1993	444
1994	689
1995	755
1996	822
1997	934
1998	866
1999	842
2000	1011

Source: DTI Motor Vehicle Product Team.
* Does not include yet exports of ABS, car stereos and other automotive electronic products, which are usually counted under electronics exports.

These part exporters are few and limited to a few components of the industry. Most have developed not necessarily in response to the progressive car/truck/motorcycle manufacturing programme, but more in relation to the global and regional strategies of the transnational car manufacturers (Ishikazaki, 1996).

F. Conclusions

For the foreseeable future, the dream of Filipino industrialists in the 1960s to develop a Filipino car or to produce a car with up to 80 per cent local content will remain a dream. The reasons are obvious. The progressive car manufacturing programme was not carried out in a consistent and sustained manner. Firstly, there was no clear strategy at the beginning. There were many ad hoc adjustments along

the way. Secondly, from five car assemblers, the number grew to 20. With a stagnant economy and too many players, most of the assemblers had a production capacity of only around 10,000 units per assembly plant per year, with actual production much smaller.

As to the increased localization of car content, the plan was never carried out in a consistent and sustained manner. Performance was hardly ever monitored. There were no clear incentives for local parts manufacturers outside the fiscal ones, such as research and development assistance or negotiations with the car assemblers on technical assistance and industry linkages.

Moreover, the tariffs for CKD parts were lowered in the mid-1990s at a rate much faster than those of CBUs. This, in effect, rendered the local content requirement policy meaningless. While there were some petitions for the extension of the deadlines for the implementation of TRIMs in the Philippines beyond 2003, these were largely ignored. With or without the TRIMs, the car parts manufacturing programme is unlikely to prosper based on local content requirements given the unilateral tariff reduction programme of the country, reinforced by the AFTA–CEPT programme and the widespread smuggling of second-hand vehicles and surplus parts.

The few successful parts manufacturers are the selected in-house manufacturers of Japanese auto TNCs (based on their global and regional plans), and the global parts exporters, which are not necessarily tied to the local car assembly industry, such as the wire harness producers.

Above all, the car industry has not developed because, as in the rest of the country, there has been a lack of industrial vision and strategic plan for the industry. It was not realistic to expect a Philippine car industry to develop merely by depending on the investment plans of transnational car makers, who, naturally, have their own global and regional plans. Unlike the Asian NICs, the Philippines failed to develop its own export and domestic champions. In electronics, it failed to scale up the value chain, to graduate from assembly work to OEM to product application and so on, just what the Republic of Korea did and what China is in the process of doing. The Philippines was an assembler 30 years ago; today, it still is. Thus, the enclave nature of the export sector has been maintained.

For the Philippines to acquire or develop the full technology or higher value added segments of a production process, local industry and Government need to work together. This was the main finding of the ADB's special report on competitiveness (Asian Development Bank, 2003). The issue is not whether FDI should be allowed to operate in some industrial enclaves, but how to transform low-skill, low-technology and cheap-labour-based export enclaves into high-skill, high-technology and professional-labour-based areas with better linkages with the economy to trigger, in the words of ADB, "a sequence of beneficial changes throughout the economy" (p. 233). Another challenge is how to encourage local enterprises to learn from FDI and acquire the skills, know-how and market for their own products.

The local content requirements are among the traditional instruments used by developing countries in speeding up and deepening the industrialization process. Handled properly, they can help promote industrial linkages and, therefore, the growth of new local suppliers and subcontractors. They may shorten the learning process in the mastery of a production process through the transfer of technology and skills. This is what Malaysia and Indonesia had been trying to accomplish (with some measure of success in the case of the former) in the development of their national car projects in the 1990s.

As to the trade-balancing requirements, it is only natural for developing countries short of foreign exchange to seek a win-win

solution on investments requiring heavy use of foreign exchange, that is, for the investors themselves to earn the foreign exchange their projects would need.

So, what can the Philippines do, if it wants to achieve a higher level of assembly work and more employment in the automotive industry?

A first step could be to promote better utilization of existing production capacity. The existing assembly plants of Toyota, Honda, Mitsubishi, Isuzu and other car makers are underutilized, some as low as 40 per cent or thereabouts. On the other hand, these "surviving" assemblers are not prepared to abandon these assembly plants in favour of the import-and-distribute business mode, which car makers from the Republic of Korea and elsewhere seem to have adopted.

One effective way of increasing the capacity utilization of these plants is to reduce the smuggling of used vehicles, which outnumber the locally assembled and the brand new legitimate CBU imports. What is needed is the political will to stop the smuggling of these second-hands.

Aside from their campaign against smuggling, the AIWA unions have also been negotiating with the Japanese car makers to assign more car models and more auto parts to be produced in the Philippines, including those for export to the ASEAN region. This is a step in the right direction. Japanese management is using the demand for more models/parts (or work to be done) by asking the unions, in turn, to help Philippine-based assemblers become more productive and competitive ASEAN- and Asia-wide. A win-win or mutually-beneficial solution to this is not impossible to forge.

A second approach could be to consolidate the role of the Philippines as a regional hub. The country has shown its capacity to produce world-class automotive parts and components such as wire harness, transmission, tire or batteries. If the Philippines can not be a regional hub for the production of cars and commercial vehicles, maybe it can be a hub for the production of more auto parts and components. What is needed is increased strategizing by the Government and the private sector on how the Philippines can be marketed in the production of global parts and components and how some Philippine producers such as Yazaki-Torres can graduate into higher value added parts production.

Thirdly, the production of AUVs could be leveraged better. Of all the vehicles assembled locally, the Philippines has registered the greatest success in the production of the AUVs. The Filipino automotive engineers, technicians and designers have managed to improve the marketability of the AUVs and increased the local content to more than 50 per cent. What has dampened the demand for AUVs in recent years are the higher excise taxes on AUVs (and lower excise taxes on imported bantam cars, which are mostly imported) and the unchecked entry of smuggled, used vehicles, most of which are 8–10 seaters. There may be a need to rethink the excise tax system, which tends to penalize local assemblers and reward importers. Once this problem and the smuggling issue are addressed, the Government and the local assembly industry should explore how the AUV industry can be strengthened and how the regional and global markets for Philippine-made AUVs can be developed.

In conclusion, in a liberalized Philippine economy and globalizing world economy, the national leaders need to come up with new and innovative measures to compete in the national and global markets. They must strategize industrial development in the context of the realities of globalization, and draw lessons from other countries, as well as from the country's own mistakes.

Notes

[1] This chapter is based on a paper prepared for UNCTAD by Ofreneo (2006).

[2] Gustav Ranis collaborated with Gerardo Sicat, the country's founding Director-General of the National Economic Development Authority (NEDA) constituted under martial law. Ranis produced a book, *Sharing in development: A programme of employment, equity and growth for the Philippines,* Manila: NEDA, 1974, which became the EOI reference book. But the ideas contained in the *Ranis Report* were virtually the same as those contained in the following: a) Myint H. 1971. *Southeast Asia's Economy: Development Policies in the 1970s.* New York: Praeger Publishers; b) Sicat G 1972. *Economic Policy and Philippine Development*. Quezon City: UP Press, 1972; and c) the various works of Hollis Chenery for the World Bank.

[3] After World War II, no Japanese openly set foot in the Philippines. Diplomatic and trade ties were normalized only in the 1970s.

[4] Interviews with officials at the Bureau of International Trade Relations of the Department of Trade and Industry (DTI) and the Motor Vehicles Division of the BOI-DTI about the notification process suggest that the notification was not a difficult process, involving a short communication to WTO on the Philippine intent to avail itself of article 5 of the TRIMs Agreement. The request did not elicit any objection from any WTO members because the Philippines explained that there was no intention to prolong the promotion of mandatory targets on local content and foreign exchange earnings for the passenger car, truck and motorcycle industry beyond the five–year period, in line with the Philippines commitment to the general liberalization of the economy.

[5] The Philippines also had a 1987 executive order requiring the soap and detergent industry to use a minimum of 60 per cent of raw materials that do not endanger the environment, and prohibits the imports of laundry soap and detergents containing less than 60 per cent of such raw materials. Meant to promote the fuller utilization of Philippine coconut-based active agents, this order was never taken seriously by the industry and was never enforced by the trade and industry officials.

[6] In particular, from the perspective of the car makers, given the fact that these are operating regionally and globally, there is no reason why they would seek an extension of the local content programme and the requirement to earn foreign exchange to be able to import CKDs/SKDs, as this affects their overall capacity to manage regional and global business operations more flexibly.

[7] For example, Yazaki Torres in Laguna and EDI in Cavite have thousands of workers producing wire harnesses destined for different automakers worldwide.

VI. Ethiopia

A. Introduction

In the past three to four decades, Ethiopia has undergone major socio-economic and political transformations, moving from a feudal to a socialist system, and more recently to an open market-based economy and democracy.[1] These changes have been accompanied by various attempts at institutional reform, including the introduction of a new Constitution in 1995.

The "socialist period", from 1975 to 1991, was marred by political turmoil, a prolonged armed civil conflict and economic restructuring based on centralized planning. A comprehensive nationalization of private enterprises, including foreign-owned, was carried out. The State controlled the economy. The private sector was reduced to micro- and small-scale manufacturing activities. By the time the socialist regime was removed in 1991, over 95 per cent of the modern sector output in food processing, textiles, beverages, tobacco and leather and footwear industries was produced by public sector manufacturing enterprises. The public sector also employed over 70 per cent of the workforce in the industrial sector. This legacy has dictated the nature and context of the policy reforms introduced in the last decade (UNCTAD, 2002: 10).

Since 1992, major reforms have been implemented, including trade liberalization, privatization of public enterprises, financial sector reforms, and deregulation of prices and exchange rate controls. In line with the more market-oriented policy, the investment regime has also been liberalized. Since 1992, the investment code has been revised more than seven times to open a wider coverage of industries and activities for foreign investors. The latest revision has broadened the industry coverage to include the telecommunications and power sectors. The Ethiopian Investment Commission, which is an autonomous government body, serves as a one-stop shop for the promotion of FDI.

After a slow start, the Ethiopian Privatization Agency has also begun to promote Ethiopia as a location for FDI. Many of the regulatory and policy constraints that bedeviled the economy in the past have been removed and the investment regime is now relatively open. As part of the investment liberalization, the Government has also restricted the use of performance requirements, including TRIMs, to better attract FDI inflow. There are still minimum size investment requirements for foreign participation in joint ventures, and some activities remain closed to FDI.

In a further attempt to anchor its trade and investment policy reform process, Ethiopia in 2003 applied for membership in WTO. This decision marked an important step in the country's process of integration into the global economy. WTO principles and obligations are expected to help Ethiopia to develop an effective trade and investment regime. In addition, pursuing WTO membership is seen by the Government as a means of enhanced its international reputation, which in turn is expected to help the country attract quality FDI. Indeed, the Government considers that WTO membership will raise investor confidence and serve as one of the instruments to attract FDI and thus help in diversifying the production base and expanding the supply capacity of the country. Accession to WTO, therefore, is seen as important to enhance credibility and overcome perceptions of high risk of policy reversals and uncertainty. [2]

As part of the accession package, Ethiopia will likely be required to commit itself to fully implementing the TRIMs Agreement, with a possible transition period. This report examines Ethiopia's investment regime with respect to the future requirements of the TRIMs Agreement. The report is structured as follows. Sections B and C briefly examine the investment policy of Ethiopia and the recent trends in FDI flows, its sectoral and regional distribution and the

incentive structure for attracting foreign investment. Section D reviews the Ethiopian investment regime in the light of the TRIMs Agreement. Specifically, it evaluates if local content requirements, trade-balancing requirements, foreign exchange and export restrictions exist in the Ethiopian trade and investment regime. Section E examines the incidence of performance requirements in a few other African developing countries. Section F presents some concluding remarks.

B. Ethiopian regulatory framework

The regulatory regime governing FDI in Ethiopia has undergone significant changes as part of the reform process that started in 1992–1993. The present regime is based on investment proclamations issued between 1996 and 2003.[3] Together, these laws establish which industries are open to FDI, the financial limits and requirements for FDI, the monitoring and reporting requirements and the available financial incentives.

1. Industries closed to FDI

Foreign investors are encouraged to invest in all industries, except those currently reserved for domestic private and State investment. The domestic private investor category includes foreign nationals who are permanent residents in Ethiopia.[4] There is a continuous review of the industries closed to FDI. While more industries are now open to FDI, those currently reserved for domestic private and public investors are still numerous. Thus, the FDI regulatory framework in Ethiopia is still highly restrictive compared to many other developing countries, including those in the region (UNCTAD, 2006).

Industries exclusively reserved for public investment include transmission and supply of electrical energy and postal services, with the exception of courier services. However, generation of electricity from hydropower is allowed for both foreign and domestic investors without any limitation on generation capacity.[5] Manufacturing of weapons and ammunitions, as well as the provision of telecommunication services, are open to both foreign and domestic investors, but only through joint venture with public bodies. A number of sectors are reserved for domestic investors: (a) wholesale trade and distribution (excluding fuel and the domestic sale of locally produced goods from FDI plants); (b) importing (except material inputs for export product); and (c) exports of raw coffee, oil seeds, pulses, hides and skins, (if bought from the market) and live sheep, goats and cattle (if not fattened by the investor).

Foreign investors are also excluded from the following services and manufacturing activities: (a) construction (excluding grade one contractors) and building maintenance; (b) tanning hides and skins up to crust level; (c) hotels other than star designated; (d) motels, tearooms, coffee shops, bars, night clubs and restaurants, excluding international and specialized restaurants; (e) tour and travel operators; (f) car-hire, taxis and commercial road and water transport; (g) grain mills; (h) barber and beauty shops; (i) goldsmiths; (j) non-export tailoring; (k) saw milling and non-export forest products; and (l) customs clearance services, museums and theaters operation and the printing sector. Banking and insurance businesses, broadcasting services, air transport services with seating capacity of up to 20 passengers are open only to Ethiopian nationals. This large exclusion of FDI is designed to encourage indigenous entrepreneurship and the domestic private sector.[6]

2. Ownership limitations and requirements

Under Proclamation 280/2002, a minimum investment amount is required for both wholly owned operations and joint ventures with Ethiopian companies or individuals. The value of the investment must

be either in cash or in-kind. However, the Government has relaxed the minimum capital required for foreign investors. Accordingly, the latest proclamation specifies that for wholly owned FDI into the open industries, an initial investment of $100,000 is required. For joint ventures with Ethiopian investors, the foreign partner is expected to contribute a minimum equity of $60,000, in either cash or capital equipment. In areas of engineering, architectural, accounting and audit services, project studies and management consultancy services, $50,000 is required if the investment is wholly owned by the foreign investor and $25,000 if it is made jointly with a domestic investor. This minimum capital requirement is not applicable for a project that reinvests its profits or dividends or exports 75 per cent of his production.[7] Apart from these minimum capitalization conditions, the investment code does not require FDI to meet specific performance goals or impose guidelines for their operations.

3. Treatment of foreign investors and government incentives

Unlike many other developing countries, Ethiopia has no separate law for FDI; the Investment Proclamation governs both domestic and foreign investment. The incentives system is also the same for domestic and foreign investors. There are, however, discriminations against FDI in terms of sub-industry restrictions (see above).

Ethiopian FDI policy does not explicitly require foreign firms to meet specific performance goals or guidelines, for instance, in terms of exports, foreign exchange, local content levels in manufactured goods, or employment limits on expatriate staff. With regard to investment incentives, foreign investors are fully exempted from customs duties and other import taxes on all capital equipment and up to 15 per cent on spare parts, as well as from export taxes. Income tax holidays vary from one to five years (depending on the industry and region within Ethiopia). In addition, foreign investors can carry forward initial operating losses and can use any depreciation method in their financial statement. These incentives apply to industries open to FDI.

Investment guarantees for FDI include full repatriation of capital and profits. This encompasses profits, dividends, interest payments on foreign loans, asset sale proceeds and technology transfer payments. There is also a guarantee against expropriation, except in major cases of public interest when full market value compensation will be paid promptly.[8] Ethiopia has signed the Convention on the Settlement of Investment Disputes. The country is also a member of the World Bank-affiliated Multilateral Investment Guarantee Agency, which issues guarantees against non-commercial risks to enterprises that invest in signatory countries. Ethiopia has also concluded bilateral investment promotion and protection agreements with a number of developed and developing countries, and the Government is keen to conclude similar treaties with more countries.

C. FDI performance

FDI inflows amounted to $205 million in 2005 (UNCTAD, 2006 – *WIR06*). Capital registered for approved projects was steadily growing until a sharp decline was observed in 1998/99 and 2001/02 (table VI.1). This could be largely attributed to the border conflict between Ethiopia and Eritrea and the subsequent economic slowdown. According to the Ethiopian Investment Commission, a total of 10,594 projects involving Birr 111 billion in capital were licensed during 1992/93–2003/04. The shares of domestic private capital, FDI and public capital were 64.2 per cent, 19.7 per cent and 16.1 per cent, respectively.

Only 59 (19.1 per cent) new and expansion FDI projects worth Birr 3.8 billion

have become operational during the 1992/93–2001/2002 period, compared to over 1,803 domestically funded projects. FDI held about 28 per cent of the value of operational project investment in Ethiopia, and concentrates in a relatively large investment projects. Of the 6,338 projects approved during the period 1992–2002, only 1,891 (22 per cent of total capital of approved projects) have commenced operation. The share of operational and under-implementation projects together constituted about 50 per cent of the total approved projects up until the end of 2002. Operational projects have already created temporary employment opportunities for about 308,587 people (60 per cent of the total approved), although permanent employment was proportionally lower than what was intended in the investment project plan.

The country has witnessed a big gap between the number of projects approved and those that commenced operations. This could be due to the unfavourable global economic trends, in particular the conflict between Ethiopia and Eritrea. Joint venture projects were found to be relatively better implemented in Ethiopia compared to wholly foreign-owned projects. This might be due to the fact that, while foreign investors take care of the delivery of equipment and machinery, their domestic counterparts follow the construction and other assignments in the country.

Table VI.1. Number and investment capital of approved projects, 1991/92-2003/04
(Number of projects and investment capital in million Birr)

Fiscal year	Domestic projects		Foreign projects		Public projects		Total	
	No.	Invest-ment	No.	Invest-ment	No.	Invest-ment	No.	Invest-ment
1992/3	542	3 750	3	233	0	0	545	3 982
1993/4	521	2 926	3	438	1	57	526	3 421
1994/5	684	4 794	7	505	2	39	693	5 338
1995/6	897	6 050	10	434	1	6	908	6 491
1996/7	752	4 447	42	2 268	1	7	795	6 722
1997/8	816	5 819	81	4 106	1	14	898	9 940
1998/9	674	3 765	30	1 380	9	4 915	713	10 060
1999/0	561	6 740	54	1 627	9	5 760	624	14 127
2000/1	633	5 573	43	2 891	5	108	679	8 572
2001/2	756	6 117	35	1 474	10	1 599	801	9 190
2002/3	1 089	7 621	83	3 514	7	8 261	1 179	11 962
2003/4	1 862	12 178	347	7 205	16	1 837	2 225	21 220
Total	9 789	69 883	741	26 108	64	15 317	10 594	111 000

Source: Ethiopian Investment Commission.

Foreign investment is concentrated (approximately 98 per cent) in the three regions of Addis Ababa, Oromia and Amhara. Addis Ababa is the capital city and Oromya is the central region with a large population and better access to the international airport of Addis Ababa and to port facilities in Djibouti and Somalia. In terms of sectoral distribution, manufacturing accounted for about 46 per cent of the total licensed FDI projects and 40 per cent of investments. Agriculture, real estate and construction took about 19.5 per cent, 18.1 per cent and 10.1 per cent of the total planned capital. Despite its potential and source of livelihood for the bulk of the population, private investment in agriculture has not been satisfactory. Poor infrastructure facilities, such as irrigation, roads, communication and power supply, inhospitable climate in some lowland areas, and problems related to acquisition of land are some of the

contributing factors for the low private FDI in the sector.

According to the Ethiopian Investment Commission, around 20 per cent of both wholly owned and joint venture projects involve investors from two (occasionally three) countries. This makes it difficult to classify accurately capital inflows by source country or region. A review of investment applications and direct contact with investors revealed that a large number of these multi-nation FDI consortia are expatriate Ethiopians (sometimes from a single family) initiating steps to invest in new projects or rebuild long-established Ethiopian businesses.

Middle Eastern investors accounted for one third of the new FDI projects and contributed about 57 per cent of the capital. Saudi Arabia is by far the largest source of investment, with Birr 7,201 million of committed capital to date, or 52 per cent of the overall FDI approved. The second most important source of FDI in Ethiopia over the period 1992/93 to 2000/01 is investors from the European Union, with a share of about 28 per cent of the projects but only 15 per cent of the new capital approved. Within the European Union, no single country had a dominant role, and investors from all major States invested in the country. Expatriate Ethiopians also invested jointly with investors from one or more countries. The remaining 28 per cent of FDI capital originated from North America, Asia (predominantly India), and non-European Union European countries.

D. The TRIMs Agreement and Ethiopia

Ethiopia is currently in the process of acceding to WTO. The country will be required to ensure full compliance with the WTO TRIMs Agreement, with possible resort to a transition period. However, judging by the experience of recently-acceded countries, enforcement of the TRIMs Agreement from the date of accession without recourse to any transitional period is a precondition to ensure accession.[9] Moreover, in accession negotiations, some WTO members have requested TRIMs plus commitments to eliminate or refrain from introducing export performance requirements, even if they are not linked to import volume or value. Such measures are beyond the scope of the TRIMs Agreement. Furthermore, requests for liberalization of the investment regime and application of national treatment to foreign investments have been made in the accession negotiations, although the TRIMs Agreement does not require commitments in these areas. Acceding countries have also been asked to provide extensive information on their foreign investment laws, beyond the scope of the TRIMs Agreement.

As already noted, Ethiopian FDI policy does not generally require foreign firms to meet specific performance goals or guidelines, for instance, in terms of export, foreign exchange restrictions for imports, minimum local content levels in manufactured goods, or employment limits on expatriate staff.

1. Local content requirements

The Ethiopian Investment Proclamation does not impose any significant requirement for the utilization of locally produced raw materials or other input. Beyond the Investment Proclamation, it is also important to consider other relevant legislation for any local sourcing requirements. In this regard, Proclamation No. 249/2001 grants certain tariff exemptions. The Export Trade Duty Incentive Scheme aims to expand the exports of manufactured goods and to attract domestic and foreign investors engaged in foreign exchange-earning activities. There are three types of incentives: Bonded Manufacturing Warehouse, Duty Draw Back and Voucher. The schemes are intended to

provide exporters with direct tax and duty free access to least cost inputs from all sources regardless of origin.[10] According to this proclamation, "Persons or Organizations wholly, partially or occasionally engaged in exporting their products will be beneficiaries of the Duty Drawback Scheme... Notwithstanding this, persons or organizations partially or occasionally engaged in exporting their products shall not be beneficiaries of the schemes established by this Proclamation, where raw materials equivalent in price and quality to those they imported are locally available."

The tax exemption advantage that comes with producing for export is not available if local inputs similar to imported ones are available. This could arguably qualify as a measure contrary to the provisions of the TRIMs Agreement as it has the effect of indirectly requiring the use of local inputs.

Another provision that might contradict the TRIMs agreement is article 8 of Regulation No. 84/2003 (Council of Ministers Regulations on Investment incentives and Investment Areas Reserved for Domestic Investors). It provides that: "(1) an investor shall be allowed to import duty free capital goods and construction materials necessary for the establishment of a new enterprise or for the expansion or upgrading of an existing enterprise. (2) In addition an investor granted with customs duty exemption privilege shall be allowed to import duty-free capital goods necessary for his enterprise. (3) Notwithstanding the provisions of Sub Articles (1) and (2) of this Article the Board [the Federal Investment Board] may, by its directives, bar the duty-free importation of capital goods and construction materials where it finds that they are locally produced with competitive price, quality and quantity."

This article gives power to the Federal Investment Board to issue directives that grant goods of foreign origin treatment less favourable than that accorded to similar products of national origin. However, the power of the Federal Investment Board is only to bar the duty free importation of capital goods and hence apply the MFN tariff on these goods where they are locally produced. Since this is a border measure, there appears to be no violation of the national treatment provision of article III.4 of GATT and of the TRIMs Agreement.

2. Trade-balancing requirements

The examination of Ethiopia's import trade regime shows that importers are required to obtain a license from the Ministry of Trade and Industry, pursuant to Proclamation No. 67/1997 (Amendment Proclamation No. 376/2003) and Council of Ministers Regulations No. 13/1997 (Amendment Regulation No. 95/2003). The importation of certain goods and materials is regulated by sectoral government offices and authorities. For example, imports of motor vehicles and transport machinery need authorization from the Road Transport Authority. However, Ethiopia does not currently have any trade-balancing requirements. Similarly, there are neither quantitative import restrictions nor import quotas. However, there is an import prohibition for items such as opium, ethyl alcohol, narcotic drugs, other spirits denatured or of any strength, worn clothing and worn textile articles and rags.[11]

3. Foreign exchange restrictions

There is no clear provision in Ethiopia's investment code which is related to foreign exchange restrictions. However, there are other regulations that may be relevant. For example, according to the

National Bank of Ethiopia directives, importers wishing to access foreign exchange have to request it, by providing import documents.[12] There are other criteria the National Bank uses in order to grant this permission.[13] However, no foreign exchange balancing requirement is included as a criterion in the directive.

Another issue that relates to the restriction of access to foreign exchange is the law governing external loans and remittances of funds. Article 19 of the Ethiopian Investment Law[14] allows for free outflow of funds. However, any contracted foreign loan (requiring externalization for repayment) that will need to be repaid, must be brought to the attention of the Bank, otherwise repayment will not be allowed. Similarly, the provision that governs remittance of funds provides:[15] "Any foreign investor shall have the right, in respect of any approved investment, to make the following remittances out of Ethiopia in convertible foreign currency at the prevailing rate of exchange on the date of remittance: (a) profits and dividends accruing from investment; (b) principal and interest payments on external loans; (c) payments related to a technology transfer agreement registered in accordance with the investment law; (d) proceeds from the sale or liquidation of an enterprise; (e) proceeds from the transfer of shares or partial ownership of an enterprise to a domestic investor."

The investment proclamation also provides that foreign investors are allowed to open foreign currency accounts in authorized local banks in accordance with directives of the National Bank of Ethiopia for transaction related to their investment. According to the National Bank of Ethiopia, eligible customers that are allowed to open foreign currency accounts are only regular recipients of foreign exchange remittance from abroad and/or an exporter of goods or services.[16] This directive clearly links the opening of a foreign account balance with "foreign exchange inflows attributable to the enterprise." However, it should be noted that paragraph 2(b) of the TRIMs Illustrative List speaks of quantitative restrictions on importation by an enterprise of products used in local production by restricting its access to foreign exchange to an amount related to the foreign exchange inflows attributable to the enterprise. The measure under review in the case of Ethiopia is not an import restriction but relates to the opening of a foreign currency account.

Although transactions involving foreign currency have been liberalized with the overall transaction process delegated to banks, in practice a comprehensive regulation by the National Bank of Ethiopia governs such transactions. Such currency regulation relates to payments in foreign exchange made by individuals, organizations and establishments on acquiring services and goods. Although not immediately TRIMs-inconsistent, these directives provide a number of restrictions. Restrictions include the tax certification requirement for repatriation of investment income, restrictions on repayments of legally-contracted external loans and supplies, foreign partners' credits, rules for the issue of import permits, and the requirement to provide a clearance certificate from the National Bank of Ethiopia to obtain import permits.[17]

4. Export restrictions

Currently, there are no significant quantitative export restrictions maintained by Ethiopia. There is, however, a prohibition on the export of raw hides and skins, which might be inconsistent with the TRIMs Agreement. Furthermore, Legal Notice No. 416/1972 restricts the export of game animals, trophies or articles made of trophies and Proclamation No. 206/2000 restricts the exportation of seeds. The Government believes the export ban on raw hides and skins serves a basic development objective.

Its elimination would affect all the industries in the leather value chain and deserves further examination.

Article XI:1 of GATT prohibits quantitative restrictions on exports of goods. Paragraph 2(c) of the Illustrative List of the Agreement on Trade-Related Investment Measures prohibits measures that are inconsistent with Article XI of GATT that involve restrictions on the exportation of goods, or sale for export of goods, by an enterprise, whether specified in terms of particular products, volume or value of products or in terms of proportion of volume or value of its local production.

Article 1 of the TRIMs Agreement says that the agreement applies to investment measures related to trade in goods only. However, it does not define investment measures. Most government export restrictions require that a raw material product must be processed locally before it can be exported. Therefore, because the raw material cannot be exported, its price will be below the world price, giving an advantage to the local processing industry. For instance, before 1993, Canada prohibited the exportation of some kinds of fish, to give advantage to the Canadian fish processing industry. A GATT panel found that this export prohibition violated XI:1 of GATT. Thus, it would also be inconsistent with the TRIMs Agreement.

The Ethiopian ban on raw hides and skins may be inconsistent with the TRIMs Agreement. The ban is primarily maintained to give an advantage to the local hides and skins processing industry. And since the basic objective is to encourage and protect local processors, that could make it an investment measure. This would suggest that the measure may also be a violation of the TRIMs Agreement.

a. The Hong Kong (China) Ministerial decision

At the 2005 Ministerial Conference in Hong Kong (China), it was agreed that LDCs shall be allowed to maintain on a temporary basis existing measures that deviate from their obligations under the TRIMs Agreement until the end of a new transition period, lasting seven years, so long as they notify the measures to the Council for Trade in Goods (CTG). Moreover, the transition period may be extended by the CTG, taking into account the individual financial, trade, and development needs of the member in question.

Thus, LDCs shall be allowed to introduce new measures that deviate from their obligation under the TRIMs Agreement. These new TRIMs shall be notified to the CTG no later than six months after their adoption. The CTG shall give positive consideration to such notifications, taking into account the individual financial, trade and development needs of the members in question. The duration of these measures will not exceed five years, renewable subject to review and decision by the CTG. Any measures incompatible with the TRIMs Agreement and adopted under this decision will be phased out by 2020.

During the accession negotiation, Ethiopia will be required to ensure full compliance with the TRIMs Agreement with possible resort to transitional period. In view of the Hong Kong (China) Ministerial Decision, Ethiopia might argue to be given a transitional period to eliminate the ban on hides and skins. However, this treatment may not come automatically, and WTO member countries that are Ethiopia's negotiating partners may not readily accept such a request. The special and differential treatment of transitional period in the Hong Kong

(China) Ministerial Decision and all the rights and privileges in the WTO Agreements for that matter relates to WTO member countries but not necessarily to acceding countries.

b. The case of raw hides and skins

What would be the possible development impact of elimination of the ban on export of raw hides and skins? It is important to first understand the domestic interests that are at stake. There are three major industrial components of the system: the tanneries producing the leather, the footwear manufacturers and the leather products manufacturers. There are large and medium-sized plants in the formal sector and micro-enterprises operating in the informal sector of the economy, particularly in footwear manufacturing.

There are currently 20 tanneries in operation in Ethiopia with direct job opportunities for about 4,000 people. Of these, nine are 100 per cent export-oriented in semi-processed skins and 14 have facilities for the treatment of effluents. A further four are expected to start operations in the near future and licenses have been issued for the establishment of an additional 18. The ban on the export of raw hides and skins is one of the principal reasons for the establishment of the tanneries, as it assures a continued non-disrupted supply of raw materials. However, the processing capacity of the tanneries far exceeds the supply of hides and skins, particularly raw sheep and goatskins. This has created an unhealthy competition among tanners, with the result that skin prices are high. This raises the price of leather to the local manufacturers of leather products and affects the capacity to compete in the export market.

The Ethiopian tanning industry addresses two market segments: (a) exports of semi-processed and finished leather, and (b) the local market for finished leather. Ten tanneries are already producing and exporting finished leather. Two have started expansion programmes for the production of finished leather and five are expanding such projects.

In addition to the tanneries, the leather product industries are found in the leather value chain. The leather product industry in Ethiopia includes the manufacture of leather shoes, shoe uppers, leather garments, bags and stitched upholstery. The producers belong to the formal and the informal sectors of the economy. The industry may be considered as composed of two groups: the larger mechanized footwear industries and the remaining production units that comprise SMEs.

The perception of the Ethiopian entrepreneurs and traders is that the full exploitation of the leather and leather goods markets in Ethiopia is limited by the lack of raw material, and that this is caused in turn by constraints such as the pre- and post-mortem defects found on raw hides and skins, inadequate curing and improper handling.

Conversely, the tanners believe that the local market for processed leather is unstable, due to the weakness of the manufacturers of leather products, who cannot, or will not, pay adequate prices for quality finished leather. In turn, the producers of leather products feel that the lack of finished leather is due to inadequacies in the tanning sector, as this is too focused on the production of semi-processed leather for the export market.[18]

The lack of finished leather is a constraint to the operation and to the development of the leather product industry. Industry experts recommend that in the short term, finished leather should be imported in order to facilitate the expansion of this sector (footwear in particular). The Government has also provided incentives to encourage import of finished leather products (see below).

One of the problems facing the industry is the lack of raw material inputs. Hides and skins are not only of poor quality, but also inadequate in quantity. Marketing of hides and skins is itself inefficient, and the pricing system adversely affects both primary producers and factories. In an attempt to resolve these problems, the Government enacted a new proclamation to create a situation where the marketing chain between the primary producer and tanning factories would be significantly shortened and more efficient.

The Ethiopian industrial strategy has identified the leather industry as one capable of accelerating economic development by creating more employment, generating income through exports, and offering investment potential. The Government wants to put Ethiopia's leather industry at the forefront of the leather sector development of the Eastern and Southern African region. Already, the Ethiopian leather products industry has reached an advanced stage of development compared to industries in the region, and has a reputation for excellence in the international market (especially for skins leather for the gloves industry).

Two concrete steps have been taken to support the industry. Firstly, it has established the Leather and Leather Products Technology Institute, whose principal function is to create technical capabilities needed to improve the competitiveness of the industries. Secondly, customs duties on import of raw hides and skins have been lifted. In spite of the high livestock endowment, the availability of hides and skins to be processed into leather is low in Ethiopia, due to low off-take ratios, a dominant factor among other factors. Industry experts recommended increased imports of raw hides and skins because the tanneries currently operate under capacity and because the leather and leather product industries currently lack sufficient processed leather inputs. In order to facilitate the expansion of this sector (footwear in particular), the Government also decided to eliminate the existing tariffs on imports of finished leather.

The industry fears that lifting the ban will have a devastating impact on the local tanneries, and leather and leather product industries. The development impact of its elimination may be the following:

- It may considerably undermine the production capacity of the Ethiopian tanneries. All of the tanneries in Ethiopia are working with only half of their capacity. Lifting the ban would lead to the closure of more of than half of the tanneries.
- It may seriously reduce the quality of the products of Ethiopian leather and leather product industries and tanneries. If exports are permitted, raw hides and skins that will be exported will be of high quality. The hides and skins that will be available locally will be the leftovers and of poor quality. Any increase of export in the context of continual deterioration of the quality of raw hides and skins may ultimately affect the competitiveness of the related industries.
- Ethiopia may lose its international name for high quality goat and sheep skins to other countries. Ethiopia is endowed with both a good quantity and quality of sheep and goat skins. If raw hides and skins were to be exported, other countries will exploit the reputation of Ethiopian highland sheepskins and goatskins after importing them.
- It may undermine efforts to generate employment. While exporting raw hides and skins requires limited manpower, domestic tanneries and leather and leather product industries generate significant employment opportunities: they currently employ between 6,000 and 7,000 people. Encouraging the industry to participate in the export market by maintaining the ban

on export of raw hides and skins may generate more employment.

- There is a fear that lifting the ban will arrest the growth of the Ethiopian leather and leather products industries. The Ethiopian Government is taking a number of measures to support the growth of these industries. One is the directive that permits the industry to import finished leather without limitation. However, the industries can not afford to buy better finished leather. Under the current circumstances, what will make them profitable is to source the finished leather from domestic tanneries instead of importing it. To source the finished leather domestically, there needs to be adequate supply of finished leather with acceptable quantity and quality. Exporting raw hides and skins may undermine this effort.
- Lifting the ban may also arrest the transition to export of higher value added products. Finished leather, crust, wet blue, pickled hides and skins, raw hides and skins command higher prices in that order. It may therefore be attractive to encourage the domestic leather industry to use locally produced raw hides and skins rather than export them in raw form.
- Some industry experts believe that lifting the ban might hinder transfers of technological know-how. Processing raw hides and skins into finished leather demands considerable technological know-how. It involves leather technologists, engineers and chemists. On the other hand, exporting raw hides and skins involves simply salting hides and skins and exporting them. The leather and leather product technology can easily be adapted by developing countries. Historically, the technology has passed from European to Asian countries. Countries such as the Republic of Korea and Japan, who first adapted the technology, are now moving to other products. In the future, the technology will be transferred to Africa. Indeed, the industry is growing in Northern Africa. Ethiopia is at forefront and could quickly familiarize itself with the know-how needed.

E. Incidence of TRIMs: comparison with other African countries

As shown above, apart from minimum capitalization conditions, the Ethiopian investment regime does not require FDI to meet specific performance goals or operations guidelines. There are no requirements in terms of export levels, foreign trade balancing, foreign exchange restrictions for imports, minimum local content levels in manufactured goods, or employment limits on expatriate staff. Once an investment project is established and operational, it is left to the company's managers to make all key decisions without government authorization or interference. If there is a TRIM, it will be found in other laws and not in the investment law.

The overall incidence of performance requirements on FDI approvals in general, and use of TRIMs in particular, declined sharply during the 1990s in other African countries as well.[19] According to trade policy reviews of different African countries conducted by WTO, the majority of African countries do not maintain any TRIMs at present. Exceptions include Egypt, Senegal, Gambia, Zambia and Nigeria.

Egypt has notified WTO that it maintains incentive measures in the form of customs duty reductions to promote the establishment and development of certain industries.[20] The reductions in customs duties, which are offered to assembly industries, depend upon the proportion of local content and can go up to a maximum of 75 per cent of the full tariff rate. The incentives were originally aimed at facilitating the exploitation of available resources, transfer of technology, and remedying what was viewed as a chronic

trade deficit. The authorities indicate that these incentives have lost their importance in the light of the recent tariff reductions and thus will be reconsidered in the near future (WTO, 2005a).

In Senegal, enterprises approved under the Investment Code are eligible for a number of benefits under the common regime and one or more of the four privileged regimes. The privileged regimes correspond to the four priority objectives of the Investment Code: the promotion of SMEs, the upgrading of local resources through processing in Senegal, the development of technological innovation through research or the use of research findings and the establishment of economic activities in regions in the interior of Senegal. Although Senegal has not notified the WTO of any TRIMs, one of the conditions of approval of projects under the privileged regime for the upgrading of local resources through processing in Senegal is that 65 per cent (in value terms) of intermediate consumption should be of Senegalese origin or that the cost of imported products should represent less than 35 per cent of the total cost of the products obtained after processing in Senegal (WTO, 2003).

Under the Gambian Investment Promotion Act of 2001, when awarding a certificate of special investment (for incentives purposes) one of the factors taken into account by the Gambia Investment Promotion and Free Zones Agency is the extent to which the applicant would use local raw materials, supplies and services. However, no formal quantitative benchmark is used, and investors may still be granted a special certificate of investment if they are deemed to have satisfied some of the other requirements set out in the act (WTO, 2004).

In Zambia, a local content of at least 40 per cent makes local suppliers eligible for a 15 per cent price preference under Zambia's tendering system. In an amendment to the Investment Act (1996), special incentives for investment in import-substitution industries using a significant proportion of local raw material and resulting in net foreign exchange savings were withdrawn (WTO, 2002).

The Government of Nigeria has notified the Committee on TRIMs that it has no local content laws or regulations pursuant to article 5.1 of the WTO TRIMs Agreement (WTO, 2005b). However, under the Investment Act, certain incentives are subject to the use of local raw materials. For instance, a tax credit of 20 per cent is granted for five years to industries that use a certain minimum level of local raw material. The minimum levels of local raw materials are, by sector: agri-allied (70 per cent), engineering (60 per cent), chemicals (60 per cent) and petrochemicals (70 per cent) (WTO, 2005b).

F. Conclusions

In recent years, there has been a general decline in the incidence of performance requirements[21] and use of TRIMs in particular. The review of the case of the African continent seems to confirm this. This trend can be explained by several factors, including (a) the need to comply with international commitments (the WTO agreement in particular has prompted Governments to withdraw the specified TRIMs); (b) the participation in regional integration and bilateral agreements, which has forced certain countries to phase out performance requirements; and (c) the increased competition countries face for FDI inflows.

In the Ethiopian context, the limited use of TRIMs is not due to Ethiopia's international commitments. Nor is it a result of Ethiopia's participation in regional integration and bilateral agreements. As has been pointed out in this chapter, until 1991, the Ethiopian economy was socialist-oriented

with economic restructuring based on a centralized planning system. After 1991, this policy direction was completely reversed. Encouragement and promotion of investment has become necessary to accelerate the economic development of the country. To widen the scope of participation of foreign and domestic investors and improve the investment environment, the current Government has revised the law on investment several times. In the Ethiopian context, therefore, the reason for the limited and almost non-usage of TRIMs is linked to the desire to avoid any requirement that would have a deterring effect on inward FDI. TRIMs are not applied for fear that performance requirements may discourage FDI inflows or affect the quality of the investments. In the course of WTO accession negotiations, Ethiopia may further reflect on the need to achieve the right balance between the liberalization and protection approach followed in the past few years and the preservation of a degree of freedom to impose development-oriented obligations on foreign investors.

Notes

1 This chapter is based on a paper prepared for UNCTAD by Mihretu (2006).

2 Ethiopian Ministry of Trade and Industry (2003), p. 1.

3 The key proclamations of these changes are Proclamations 7/1996, 37/1996, 35/1998, 36/1998, 16/1998, 168/1999 and 280/2002 and 375/2003.

4 Foreign nationals of Ethiopian origin will be considered as domestic investors pursuant to Proclamation 270/2002 even when they are not permanent residents of Ethiopia as long as they have an Identification Card attesting their Ethiopian origin.

5 See Article 5 of Proclamation 280/2002.

6 Council of Ministers Regulation No. 84/2003.

7 The intention behind setting a certain threshold level for FDI might be to attract large foreign projects and reserve small-scale ventures to domestic investors. However, given the limited resources to undertake promotional activities, imposing such a requirement might also restrict foreign investors who are unable to meet the minimum requirement.

8 See article 21 of Proclamation 280/2002.

9 See UNCTAD (2004). Both Nepal and Cambodia committed themselves to fully implementing the TRIMs Agreement, waiving the seven-year transition period allowed for LDCs under it. In choosing such a policy course, the two countries have decided to forego allowable policy space in an issue area where the debate about post-Uruguay Round implementation has been prominent. The decision of both countries would appear to be motivated by the absence of any current measures deemed inconsistent with the TRIMs Agreement.

10 Ethiopian Ministry of Trade and Industry (2003), p. 46.

11 Ethiopian Ministry of Trade and Industry (2003), p. 47.

12 National Bank of Ethiopia. *Directive to Transfer NBE's Foreign Exchange Functions to Commercial Banks Directive No.FXD/07/1998*, article 5.1. The import documents essentially includes an application form duly filled, three copies of *pro forma* invoices, photocopy of valid trade licenses, insurance certificate, and clearance certificate.

13 Importers who wish to import goods by advance payment are required to submit a letter of undertaking for the entry of the goods into the country in addition to the documents indicated in footnote 8. Other requirements include: (a) Ministry of Health certificate if the import of the good is medicines and other related medical equipments; (b) Ministry of Agriculture certificate for the import of agriculture chemical and veterinary medicines; (c) Quality and Standard Authority certificate for import of goods such as food, matches, nails, galvanized corrugated sheets, scales, etc, which require standardization; (d) Road Transport Authority approval as per Road Transport Regulation Proclamation No. 14/992; and (e) a copy of a loan or grant agreement concluded between Governmental Agencies and foreign financing organizations. See Article 5.5 of NBE Directive No FXD/07/1998.

14 Article 19 of Investment Proclamation No.280/2002.

15 Article 20 of Investment Proclamation No.280/2002.

16 The operation of Foreign Exchange Bureaux Directive No.FXD/09/1998, Article 5.

17 AfDB/OECD (2004), p. 140 et seq.

18 They say instead of concentrating on producing only semi-finished leather (wet-blue/crust), there must be an increase of the production of finished leather, thus boosting the local leather products industry.

[19] UNCTAD (2003), p.16. In 1991, 33 per cent of FDI approvals contained performance requirements. This proportion has fallen gradually to just about 9 per cent by 2000.

[20] WTO document G/TRIM/N/1/EGY/1, 9 October 1995.

[21] UNCTAD (2003), p. 18.

VII. Viet Nam

A. Introduction

Viet Nam has applied a number of trade-related investment measures (TRIMs) that contradict the WTO TRIMs Agreement.[1] Many of them have been eliminated unilaterally or in conjunction to the implementation of the Viet Nam-US Bilateral Trade Agreement (BTA). Ultimately, when becoming a member of the World Trade Organization, Viet Nam has to eliminate such remaining TRIMs as the mandatory localization requirements for investment in automobile, motorcycle, and electronic products manufacturing and assembly.

The effects of the TRIMs on individual industries in Viet Nam vary. Investment activities prompted by measures such as tariff protection linked to local content or the applicability of favourable rates of corporate income tax, and land lease conditional on certain criteria being met by the foreign investors, will likely be reversed when such TRIMs are removed. Furthermore, TRIMs do not appear to have resulted in the expected technology transfers to domestic firms. There is no convincing evidence of either high-tech achievement or design activities in industries in which TRIMs have been applied.

Local content requirements may also have kept some foreign investors away. Domestic value added could have been part of the rationale for local content requirements, but local content is, in practice, often of low quality and therefore plays a small role in export growth. Export requirements, restrictions on imports and some exports, and control on foreign exchange holdings, have been used to preserve the equilibrium of the balance of payment. However, the regulations have never been fully implemented, and some have already been eliminated.

The regulation on the foreign investor obligation for the development of local raw material for processing projects made them less competitive because Viet Nam did not have a comparative advantage in the production of raw materials for milk, sugar and vegetable oil processing. With regard to the supply of wood, the issue may be less clear, but the regulations have created certain difficulties for foreign investors.

Incentives in the form of preferential import tariff rates contingent upon localization ratios have led to distortions in the cost ratio between goods produced in Viet Nam and those produced abroad. Given that products with components/spare parts made in Viet Nam are mostly sold in the domestic market, this has mainly implied either higher prices or lower quality, and in either case, it narrows the domestic market and indirectly reduces the production of foreign invested enterprises (FIEs). In this respect, the effect of the TRIMs related to tariff rates has not been favourable.

TRIMs appear to have been the most useful for the assembly and production of motorcycles. The measures applied to automobiles, and consumer electronics appear to have benefited local producers but have not been helpful in achieving the objectives for which the measures were initially adopted. Consumers of automobiles and electronics goods have in effect had to pay high prices or use products of lower quality. The application of WTO rules may turn out to be particularly challenging for the consumer electronics and automobile industries.

Even though the regulations on development of local raw materials have not been fully implemented, they have weakened the competitiveness of most enterprises that process sugar, vegetable oils and milk. The failure of the regulation is most apparent for sugar cane. Nearly a decade since the adoption of the regulation, shortage of cane supply has been chronic. Even with non-tariff

protection, over a third of the sugar mills have often been making big losses.[2]

Finally, from a macroeconomic perspective, if the TRIMs have had some positive impacts, such as in the areas of foreign exchange savings, employment and tax revenues, as policymakers also intended, these positive effects were relatively moderate.

This chapter analyses the impact of TRIMs in Viet Nam. It considers the motives for introducing the measures, as well as the reasons for their failures and successes. The investment policy has been designed to serve Viet Nam's industrialization and modernization efforts. The chapter focuses on the challenges directly related to the elimination of existing TRIMs and is organized as follows. Section B provides a general background to foreign investment in Viet Nam, and describes the Law on Foreign Investment. Section C focuses on the regulations which would likely fall under the purview of the TRIMs Agreement.[3] It also considers the ideas behind individual TRIMs implemented in Viet Nam and how they have worked in practice. Section D presents an industry-based analysis of TRIMs and the possible impacts of their elimination. Finally, section E offers some concluding remarks.

B. Foreign investment in Viet Nam

1. General policies on foreign investment

A year after launching Doi Moi (Vietnamese version of economic renovation), in December 1987, the National Assembly of Viet Nam passed the Law of Foreign Investment (LFI) with the aim of expanding economic cooperation with other countries, fostering industrialization and modernization of the economy, while relying on the development and efficient utilization of the country's resources. The LFI was further improved and amended in 1990, 1992, 1996 and, most recently, in 2000.[4] In addition, State bodies at different levels of Government have issued hundreds of procedural documents on issues related to foreign investment.

The LFI stipulates that foreign investors are allowed to invest in all sectors of the economy, except in areas where it may harm national defense, security, cultural and historical monuments, traditions and the environment. A foreign investment project is encouraged if it belongs to one of the following groups: (a) export-oriented production of goods; (b) agricultural, forestry and aquatic sectors; (c) high-tech facilities, protecting ecological environment, or performs research and development; (d) users of intensive labour or natural resources of Viet Nam; and (e) builders of infrastructure and the industrial base. In addition, the Government encourages foreign investment in areas with difficult social and economic conditions and in special industrial zones and export-processing zones (EPZs). In such areas, investors are given preferential treatment, often by way of, for example, easy licensing, provision of land, favourable land rents, lower enterprise income taxes, or tax rebates.

Foreign enterprises are exempted from tariffs on imported goods that are used as fixed assets (e.g. machinery, equipment, transport equipment and building materials that cannot be produced in Viet Nam). Projects in the geographical areas where investment is encouraged and projects for the production of mechanical, electrical and electronic components and spare parts are also exempted from tariffs in the first five years of operation. The regular rate of corporate income tax is 28 per cent, which applies to foreign and domestic enterprises alike. However, lower rates apply to encouraged investment projects under certain conditions.[5] Enterprises licensed after December 2003 and located in EPZs or industrial zones pay only 20 per cent income

tax over the first 10 years of operation. Moreover, they are exempted from paying the tax in the first two years with taxable income, and enjoy a 50 per cent reduced rate in the three following years. The tax rate after 10 years of operation is the regular rate of 28 per cent. Additional incentives are provided at the sub-national level. These incentives often involve reduced rents and income tax rebates.

According to Government Decrees No. 24 of 2000 and No. 27 of 2003, and their supporting documents, for some foreign investment projects certain conditions are imposed.[6] There are restrictions on the legal forms foreign investors are allowed to use to invest in Viet Nam. The permitted forms include business cooperation contracts, joint venture enterprises and foreign invested enterprises. Joint-venture enterprises and FIEs have to be limited liability companies.[7]

The LFI also contains provisions on fair treatment of foreign investors and the protection of property rights. Viet Nam guarantees that foreign investors' capital and other assets shall not be confiscated through administrative measures, and that FIEs shall not be nationalized. Foreign investors are entitled to remit their invested capital, profit, and other lawful incomes abroad.

Together with the gradual improvement of the legal system related to foreign investment, the Government of Viet Nam has concluded 46 bilateral agreements on the promotion and protection of investments. In addition, the Viet Nam–United States bilateral trade agreement (BTA) includes a chapter on investment. With respect to multilateral cooperation, the Government has signed the ASEAN Framework Agreement on Investment, and participates in the programme of actions for the promotion of Asia–Europe investment. The country is also working on the national programme of actions for investment liberalization within the Asia Pacific Economic Cooperation.

2. Foreign investment in Viet Nam

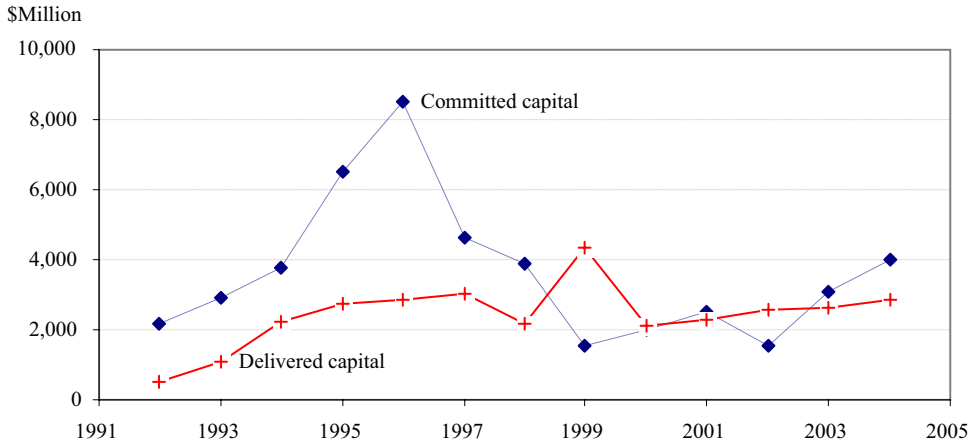
Capital inflows to Viet Nam over the last decade are shown in Figure VII.1. As of April 2005, there were 5,324 foreign invested projects in operation, with total registered capital of about $48 billion. Manufacturing, energy and construction had been the most attractive areas for foreign investors, accounting for over two thirds of the total number of projects, and 57 per cent of total foreign registered capital. The service sector accounted for 19.5 per cent of all projects, and 35 per cent of the total registered capital. Agriculture, forestry and fishery made up 14 per cent of projects and 7 per cent of the total registered capital.

The environment for FDI varies by region. The main southern economic area, which consists of Ho Chi Minh City, Dong Nai, Binh Duong and Ba Ria-Vung Tau, is considered the most liberal. It has received 56 per cent of total FDI. The main Northern economic area, Ha Noi, Hai Phong, Hai Duong, Vinh Phuc and Quang Ninh has attracted 26 per cent of total foreign registered capital. There are many industrial zones and EPZs in Viet Nam, hosting about 1,400 foreign invested projects (excluding projects in infrastructure development) for an amount of $11 billion, or about 28 per cent of total foreign investment.

Over the past 15 years, foreign investment has played an important role in Viet Nam by contributing much-needed capital. Viet Nam could not have grown at the rate it has without FDI. According to data of the General Statistical Office (GSO), 42.5 per cent of the industrial output growth over the five-year period 1999–2003 can be attributed to the foreign-owned sector (Statistical Yearbook, 2002; GSO, 2004). Over the period 1996–2004, foreign invested capital made up 20 per cent of total investment. As more capital became available, domestic resources (labour, land and others) have been utilized more

efficiently. The contribution of FIEs in the GDP of Viet Nam has increased over time: 6.3 per cent in 1995, 10.1 per cent in 1998, and 14.8 per cent in 2004.

Figure VII.1. FDI inflow to Viet Nam 1992–2004
(Millions of dollars)



Source: Ministry of Planning and Investment (2005).

C. Trade-related investment measures in Viet Nam

This section presents parts of Viet Nam's regulatory system that are likely to be affected by the TRIMs Agreement. In addition, it also touches on measures considered as operational requirements by some of the major trade partners of Viet Nam. Viet Nam has committed to eliminate some requirements as part of the Viet Nam–United States BTA and Japan–Viet Nam agreement for the liberalization, promotion and protection of investment. Vietnamese TRIMs have been designed to serve multiple purposes, including:

- Substituting local production for imports of components and spare parts;
- Fostering local technological capability, improving quality and reducing prices for products such as automobiles and motorcycles, and electrical, electronic and mechanical equipments; and
- Building local capacity for the processing of raw materials.

An important objective of the Government is to modernize local enterprises, including the State-owned ones, as well as to create jobs. In this context, it has used a number of investment measures that may or may not be in compliance with WTO rules. The Government has gradually eliminated ineffective measures, some of which are prohibited under the TRIMs Agreement. Mandatory TRIMs as conditions for project licensing used in the past have, in large measure, already been abandoned. Instead, in order to encourage enterprises to satisfy the stipulated conditions, the Government provides certain incentives.

1. Regulations on localization and development of local raw materials

During the period 1987–1994, [8] localization requirements were used in the appraisal and licensing of foreign investment projects concerning the production of automobiles, motorcycles, electronic products, and processing of cane sugar, milk and vegetable oils. It was institutionalized with the 1996 amendment of the LFI, with the State Committee for Cooperation and Investment's Circular 215, [9] and with the Government Decree 18 of 1997 [10] on the

implementation of the 1996 amendment to the LFI. The requirement stipulated certain levels of local content for products of foreign investment projects. Even though the list of projects subjected to the regulation has changed, it remained largely in effect until WTO accession.

In production and assembly of automobiles, companies have to submit a plan for components and spare parts production in Viet Nam to receive an investment license. Five years from the starting date of production at the latest, the project has to use components and spare parts made in Viet Nam for a value of no less than 5 per cent of the automobile ex-factory cost of production.[11] The ratio then progressively increases so that in the 10th year, the value of the locally-made spare parts and components should be no less than 30 per cent of the automobile ex-factory cost of production.

With respect to motorcycles production and assembly, licenses are not granted to projects using imported complete knockdown (CKD) components. In the second year from the start of production, the local motorcycle part content has to represent 5 to 10 per cent of the finished product, and after five to six years of production, at least 60 per cent of the production cost should constitute parts and components made in Viet Nam.

Assembly of mechanical, electric and electronic products can be licensed only if incomplete knockdown (IKD) components are used, instead of CKD or semi-knockdown (SKD) components, and if the production cost of the parts made in Viet Nam accounts for at least 20 per cent of total production cost in the first two years. The ratio increases over time.

Local content regulations (LCRs) apply also to projects using agriculture products as inputs, such as wood, milk, vegetable oils and cane sugar processing. The Government requires that foreign investment projects contain subprojects for development of local sources of raw material to be used for their production. For United States investors, as a result of the Viet Nam–United States BTA ratified in December 2001, this requirement will be eliminated in December 2006.

Since January 1999, while maintaining the requirements on localization and development of local resources and raw materials, Vietnamese authorities have issued a series of legal documents regulating preferential treatment for certain projects. The Inter-ministerial Circular 176 of December 1998 stipulates that preferential tariff rates dependent on the ratio of local content apply to Vietnamese companies and FIEs that are (a) producing and/or assembling completed mechanical, electric and electronic products (which are subject to tariff rates of 30 per cent or higher); and (b) producing and/or assembling mechanical components and spare parts of the above products (which are also subject to tariff rates of 30 per cent or higher).

In order to qualify for tariff rate reduction, enterprises have to declare their ratio of local content. The ratio is subsequently checked by the authorities. The actual tariff rate is determined by two criteria: the enterprise's ratio of local content (which is based on actual performance of the enterprise), and the MFN tariff rate of the imported components. Similar schedules exist for consumer electronic goods, mechanical and electric products or their parts, and to final products, when shipped from EPZs to the domestic market. As a result, the tariff policy works in favour of local production of components/spare parts and against that of complete products. As of March 2003, the regulation that made MFN import tariffs

contingent upon localization ratios in the area of two-wheel motorcycle parts was lifted.[12] For automobile parts and mechanical, electric and electronic components, the regulations, however, continue to be in effect until the completion of a certain period of transition following the date of WTO accession.

There are some supporting measures that relate to the import substitution policy. For example, the tariff rate on imported sugar was 10 per cent in 1992, but increased to 45 per cent in 1999. Moreover, sugar imports are subject to non-tariff barriers, which are determined by individual permits by the Ministry of Trade. Decisions on sugar imports are often taken in consultation with the Ministry of Agriculture and Rural Development, as well as with the Association of cane sugar producers on the basis of supply and demand trends.

The excise tax is another form of restriction. An 80 per cent excise tax is imposed on imported new cars, and a 200 per cent tax on imported second-hand cars. While the effectiveness of the tariff system on production is not immediately clear, it raises the price of the affected products, thus favouring local production.

The above-mentioned measures support the contention that the Government wanted not only to hold on to the production of import substitutes, but also to promote these industries. For instance, the Government aims to foster the auto industry, and even if there is currently little opportunity for Vietnamese enterprises to produce whole vehicles, it seeks to expand the production of vehicle parts (see box VII.1). While Viet Nam is committed to integrating in the global economy, it has not been willing to stop completely fostering its infant industries.

Box VII.1. Protection in the motor vehicle industry

For the motor vehicle industry, while domestic motorcycle assembly enterprises imported CKD spare parts and paid tariff duties at a rate of 55–60 per cent, FIEs imported IKD and paid a lower rate of tariff at 10–30 per cent. However, in order to qualify for the importation of IKD, the enterprises had to conduct certain operations such as pressing, painting, welding, etc. in Viet Nam, and had to declare the ratio of local content. That caused their costs to increase. In 2000, imported Chinese motorcycles (made in China or assembled in Viet Nam using imported Chinese IKD) increased rapidly and achieved about the same market share as Honda. For a number of reasons, motorcycles with components made in China are sold at a very low price in Viet Nam, and that has disrupted the businesses of both Vietnamese and Japanese motorcycle producers in the country.

The Vietnamese authorities' policy was to create incentives for using the locally-produced spare parts by setting tariffs on the basis of the local content level. However, this created a burden on both the Vietnamese assembly plants and on the FIEs. While Vietnamese authorities have argued that the FIEs can buy many of the spare parts from local producers, Japanese producers found that even if they wanted to order locally-produced spare parts to cut costs, the quality of such products was not acceptable. Thus, in case of the motor vehicle industry, the tariff policy goals could not be achieved.

Source: Hirofumi (2003).

Assessment of LCRs

An explicit list of stated policy objectives for the TRIMs does not exist. However, the purposes of the localization measures can be inferred from the Government's description of the localization process, which is stated to be the "production or assembly of import substitutes".[13] The goals behind the production localization measures and the development of local raw

materials were increased exports, reduced imports, employment protection, absorption of advanced technologies and industrial upgrading. Policymakers seem to have been influenced by the desirability of these objectives, while underestimating their feasibility. In particular, it was difficult for policymakers to forecast the need for natural resources (in terms of raw materials) to support larger scale production in the relevant industries and in the context of greater openness of the economy. Market size is an important factor behind the success or failure of LCRs. As the subsequent section will show, different market size helps to explain the diverging impacts of TRIMs applied in the automobile and motorcycle industry, respectively.

Only a few enterprises responded to the LCRs. According to the Government notification under article 5.1 of the TRIMs Agreement[14], by October 2003, "there have been 100 enterprises registering implementation of localization programme, of which 64 per cent are FDI enterprises and 36 per cent are local enterprises. These enterprises have registered LC ratios for 700 products, most of which are motorcycle spare parts, electronics products, refrigerators and air conditioners, household appliances". Thus, local enterprises participating in the programme represent only a fraction of the enterprises in the respective industries.

Even though it is time for Viet Nam to implement fully the Viet Nam–United States BTA and to deliver according to the terms of its WTO accession, there has been little reflection on the progress of Vietnamese enterprises, in either the automobile or electronic industry, in terms of production or acquisition of advanced technology. The effect of localization regulations on modernization appears limited. Vietnamese enterprises participate only in the low-tech segments of either automobiles or consumer electronic production. In this regard, Nguyen Thi Thanh Ha and Nguyen Van Tien (2004) report that, in 2003, 80 per cent of Viet Nam-made electronic goods were assembled from CKD components and the rest from either SKD or IKD components. The authors concluded that Viet Nam did not seem to have any special comparative advantage, as it only had cheap labour to offer. Other important factors of this industry, such as technology and trademarks, were not among Viet Nam's strengths. The situation in the automobile industry is also not very encouraging because of the poor quality of local products (see box VII.1).

Thus, Vietnamese enterprises have not been modernized to the extent hoped for, and for that reason, the pressure created by LCRs has not been very helpful. As mentioned earlier, the mandatory LCRs were subsequently supplemented by additional incentives in terms of a scheme of preferential tariff rates dependent on the ratio of local content. Due to its adverse effect, the scheme is no longer applied to the motorcycle industry. Experts in the Ministry of Finance stress that preferential tariff has not paid off in the automobile industry.[15] More generally, there is no report on any positive impact of the preferential tariff on the concerned sectors.

2. Regulations on foreign exchange and trade balancing

Given its limited reserves of hard foreign currencies to meet the demand for imports, and the constant attention to macroeconomic stability, which can be threatened by disturbances in foreign reserves, the authorities have sought to limit the outflow of foreign currency. For this reason, the Government introduced requirements on trade balancing and foreign exchange balancing by enterprises.

The LFI prior to 2000 stipulated that "[e]nterprises with foreign-owned capital and parties to business cooperation contracts shall, by themselves, meet the demand of

foreign currency for their operations" (article 33 of the 1996 LFI). This seemingly loose provision should be read in conjunction with the concurrent restrictions on access to foreign currencies. Foreign exchange earners had to sell to State banks a portion of their revenues in foreign currencies (the so-called foreign exchange surrender requirement). The FIEs and foreign parties in Business Cooperation Contracts (BCC) could purchase foreign currencies only from authorized commercial banks that were licensed to trade in foreign currencies in Viet Nam. In this way, the above-mentioned article 33 of the LFI was close to a foreign exchange balancing requirement.

Control of access to foreign exchange was gradually eased. By 1998, the foreign exchange surrender ratio was 80 per cent. It was reduced to 50 per cent in August 1999, to 40 per cent in 2001, and to 30 per cent in 2002. Finally, by the Prime Minister's Decision 46 of 2003, the foreign exchange surrendering obligation was totally eliminated. Prior to that, the 2000 amendment to the LFI had already eliminated the requirement of self-balance in foreign exchange, allowing FIEs and foreign partners in BCC to purchase foreign currencies from any commercial bank to meet their needs.

Even though the LFI contains no provision on trade balancing in general, some regulations affect foreign traders and travel company representative offices and branches in Viet Nam. These Vietnamese entities with foreign exchange earnings deriving from the exportation of Vietnamese goods were allowed to import goods for sale in Viet Nam (if so permitted by the Ministry of Trade), but the values of the imports could not exceed the values of their exports.[16] However, this regulation is also no longer effective.

In addition, Viet Nam previously applied a number of measures to restrict imports, including non-tariff measures, which were not meant to protect any particular industry, but instead aimed to safeguard foreign exchange reserves.[17] However, in 2001, this requirement was eliminated, partly in conjunction with the implementation of the Viet Nam–United States BTA. As a result, Viet Nam does not appear to have any foreign exchange or trade balancing requirements in force that would be in violation of the TRIMs Agreement.

Assessment of regulations on foreign exchange and trade balancing

While there may be good reasons for a Government to care about a country's foreign reserves, it may be difficult to apply foreign exchange restrictions at the level of individual enterprises. Enterprises have diversified activities. Some export and others import, so they may offset each other's demand for foreign exchange. The requirements on foreign exchange substantially limited the activities of FIEs that were subject to the regulation. In addition, remittance inflows are significant for Viet Nam. It is estimated that from 1991 to 2004, total overseas remittances were about $15.5 billion,[18] which was enough to make up for the total trade deficit over the period. Thus, the existence of regulations on foreign exchange and trade balancing may have been unnecessarily stringent, as it may have harmed growth prospects in the private sector.

Another aspect in this context is the existence of a parallel market for foreign exchange, through which traders can circumvent the regulation. Dollarization has been relatively high in Viet Nam, between 20 and 24 per cent in the mid-1990s and increasing over the course of the Asian financial crisis. In August 2001, dollarization had reached 34 per cent (IMF, 2002). With such significant circulation of foreign currency in the market, private agents can easily access them informally. The regulation is likely to have fuelled this parallel market,

while at the same time made enterprises in Viet Nam less competitive.

3. Restrictions on imports

Viet Nam has been using quantitative restriction on imports of sugar (Dimaranan, Le Thuc Duc and Martin, 2005). Sugar imports are currently subject to Government authorization. When supply is short in the domestic market, the Ministry of Trade, upon the Prime Minister's agreement, can issue licenses to State trading enterprises with identified amounts they are allowed to import.

In Viet Nam, State-owned enterprises (SOEs) have significant privileges, particularly in the area of foreign trade. For instance, the Viet Nam Cement Corporation (VNCC) has decisive influence on the allocation of quotas for clinker imports to enterprises in the cement industry.[19] This industry has been regulated by the VNCC, as the corporation has been controlling the domestic resource utilization, as well as the importation of inputs.

Regulation on procurement is also a form of import restriction. For the purpose of local resource utilization, the LFI before 2000 required that FIEs, in their purchases, gave priority to domestic over imported products, if commercial conditions were equivalent. However, the 2000 amendments eliminated the requirements on purchasing local commodities and replaced them with an encouragement to purchase Vietnamese products instead of importing in case of equivalent commercial conditions.[20] This was a vague provision, as it was difficult to ascertain what was meant by "same commercial conditions". It created significant scope for arbitrary decisions by provincial officers in departments of planning and investment, and of customs officers in relation to licenses and tariff rates. If some item is vital for proposed or existing projects, and the authorities believe the item to be in equal commercial condition to some domestically made product, this may lead to the rejection of the proposed projects or in delays for the operation of existing ones.

Furthermore, Viet Nam does not possess large iron ore resources suitable for large-scale steel production. The available iron ore mines are reported to be of low quality and dispersed. Import of scrap metal by steel producers was not allowed until April 2004.

Assessment of import restrictions

Consumers have borne the burden of the protective policies. Negative impacts may not only come in terms of high prices, as Government agencies are often required to take measures to keep markets under control. For instance, Government Decree 170 of 2003 stipulates that the price of cement should be stable within a certain range.[21] When prices exceeded the limits because supply was short and imports not allowed, the Ministry of Finance often exercised its "price stabilization" function and allowed taxpayers' money to subsidize cement.

The effect of this policy on the growth of infant industries has been weak. Currently, the cement industry is protected by a 30 per cent tariff and it is not sure whether Vietnamese cement enterprises will survive when the tariff rate is reduced to 21 per cent in 2006 as required by the Viet Nam–United States BTA. For the cane sugar industry, while the world price of sugar fluctuated between $200 and $315 per ton over the period 1997–2000, the price of sugar in Viet Nam never dropped below $350 per ton. Local sugar mills are only partly responsible for the lack of competitiveness of the Vietnamese sugar industry, as it is also due to land and climatic conditions.

Some FIEs have benefited from the import restrictions. FDI in Viet Nam has been directed towards industries with relatively

high levels of protection (Fukase and Martin, 1999). For instance, it was observed that among the five industries, which were the highest recipients of FDI in the traded goods sector — cement, fuels, vehicles, electrical machinery and beverages – all but the fuel sector were producing import-substituting goods (McCarty, 1998).

4. Regulations on exports

The Government of Viet Nam regulates exporting activities in two ways: it prohibits the exportation of certain commodities and requires that the FIEs produce certain other commodities to export most of their outputs.

a. Export restrictions

In line with the general policy on encouragement of exports, there are no provisions limiting export for either domestic enterprises or FIEs. However, while encouraging enterprises to export processed products, which are believed to incorporate value added, Viet Nam banned exportation of raw materials, such as minerals, wood and others. The effect of this regulation on export is ambiguous because the material can be used in products for export.

Because of the regulation, some domestic enterprises conducted processing operations solely for making the commodities exportable, and in that sense, the regulation gave rise to inefficiencies. By Circular 02 of March 2000 of the Ministry of Industry, the restriction was amended to allow FIEs to export certain minerals and to narrow the list of materials banned from exportation. [22] Subsequently, in February 2004, a joint Canadian–Vietnamese corporation was licensed to open the country's largest mineral mining project. According to the plan, the company will export more than 80 per cent of its products, which consist of tungsten trioxide, fluorspar, bismuth and copper containing gold after smelting.[23]

Export restrictions have had some positive effects. In the past, the Government banned exports of scrap metals. This helped to keep the domestic price of scrap low, and billet production reasonably competitive because of access to under-priced scrap. However, as the stock of scrap metals is running out, the competitiveness of Vietnamese steel producers can hardly be maintained. Hence, the positive effects of export restrictions may be short-lived.

b. Export requirements

Although generally not prohibited under the TRIMs Agreement, an obligation to export is a discriminatory measure against FIEs. In the past, it was required that foreign investment projects producing items which were in sufficient supply (in both quality and quantity) in the domestic market export at least 80 per cent of their output. The regulation aimed at protecting local enterprises, increasing exports and sorting out technology. [24] The requirement served not only as a condition for receiving a license, but also as the qualification for preferential enterprise income tax treatment. Eligible FIEs would pay income tax at the rate applicable to the list of specifically encouraged types of foreign investment.

According to Decision 229 of April 1998 by the Ministry of Planning and Investment, the 80 per cent export requirement applied to 24 products. [25] However, under the terms of the Viet Nam–United States BTA, which took effect in 2001, the list was reduced to 14 products.[26] In December 2001, the ministry revised the list of products subject to export requirement.[27] Finally, in 2003, the requirement was eliminated and the obligation is no longer a condition for licensing.

Assessment of export regulations

In the early days of the FDI attraction policy, the Government pushed for both import substitution and export promotion. However, actual licenses were mainly issued for projects in the first group. Among the traded goods industries, cement, vehicles, electrical machinery and beverages were the top recipients of FDI. While FIEs producing import substitutes expanded and produced a competitive effect on local Vietnamese enterprises, performance of FIEs in terms of exporting capacity has been mixed. Trade data demonstrates that, although the total exports of FIEs have been growing at a relatively high rate, the major exporters are in labour-intensive manufacturing, such as garment, footwear and assembled consumer electronics, which all carry low value added. Important exceptions include Fujitsu–Viet Nam and Orion–Hanel in electronics, and to a lesser extent, Honda–Viet Nam in motorcycles.

The rationale for the export requirement as applied to FIEs was that a specific product had already been sufficiently supplied in quantity and quality to the domestic market. However, this situation is hard to ascertain in practice, and the Government has often done so arbitrarily. For instance, the strong commitment to the development of the cane sugar industry meant that new enterprises in this industry were required to export 30 per cent or more of their outputs. This has never been feasible in practice, because of the much lower world market price of sugar. In steel, cement, paper and many other industries, the situation has been similar.

While enterprises with strong export performance have made an important contribution in this area, production linkages with the local economy have remained generally limited. Fujitsu is a case in point. Its products are mostly exported and shipped to other Fujitsu plants in the region. All design and high-tech manufacture operations are carried out outside Viet Nam. Only either basic manufacture or simple assembling is performed in Viet Nam, with little technological spillover.

Furthermore, the administration of export requirements has not been strict, and many foreign investors have not honoured their commitments. In fact, many FIEs pledged high rates of export in order to get licenses for investment, but then repeatedly asked for adjustment to the terms of the licenses to lower the export obligations. Others made similar pledges to obtain income tax preferences, but again failed to live up to their commitments.[28] In addition, in the context of an insufficiently developed legal system, the disputes between interrelated non-performing business partners are often hard to resolve. This further weakens the feasibility of the export requirement. Thus, such requirements have not been a prime factor behind the growth of exports from Viet Nam.

D. Impacts of TRIMs elimination on selected industries

The TRIMs, as well as their elimination, have affected different industries unevenly. The clearest impacts are found in protected industries. The elimination of remaining prohibited TRIMs should have the most direct impact on industries that produce and/or assemble automobiles, motorcycles and consumer electronics, processing milk, cane sugar, vegetable oils, and manufacturing wood products.

1. Automobile manufacture and assembly

The automobile industry is still at a low stage of development, but the Government deems it of strategic value for its potential for high value added production, employment creation and linkages to other industries. Viet Nam is a latecomer to this

industry. If compared to some countries in ASEAN, such as Thailand and Malaysia, its automobile industry lags behind. However, thanks to the relatively good performance of its economy over the past 15 years, Viet Nam has become a potential location for automobile manufacturers.

There are currently 11 joint ventures[29] licensed to manufacture and/or assemble automobiles in Viet Nam, with $572 million in total registered capital (table VII.1). While the foreign counterparts include some of the world's largest corporations, the Vietnamese partners are all SOEs. Current total capacity of these joint ventures is almost 150,000 vehicles per year, including nearly all types of vehicles being sold in Viet Nam. However, only one enterprise assembles trucks.

Table VII.1. Automobile projects in operation, 2005

	Foreign partners	Date of License	Registered capital ($ million)	Capital share Domestic/ Foreign
1	Isuzu	30/09/1989	50.0	30/70
2	Mekong Auto	22/06/1991	36.0	30/70
3	VMC	19/08/1991	58.0	30/70
4	VIDAMCO	14/12/1993	32.2	0/100
5	VinaStar	23/04/1994	50.0	25/75
6	Mercedes-Benz	14/04/1995	70.0	30/70
7	VIDANCO	14/04/1995	32.0	33/67
8	Suzuki	21/04/1995	34.2	30/70
9	Ford	05/09/1995	102.7	25/75
10	Toyota	05/09/1995	89.6	20/80
11	Hino	18/06/1999	17.0	33/67

Source: Department of Foreign Investment – Ministry of Planning and Investment (2004).

The development strategy for Viet Nam's automobile industry is to move it from simple assembly to localized production of components and spare parts. The Prime Minister's decision, ratified in December 2002,[30] on the Strategy of the Automobile Industry until 2010 and Vision to 2020, stipulates that regular vehicles (including trucks, buses and cars), as well as special-purpose vehicles, have to have a local content of 60 per cent or more by 2010. This target was reiterated in the Government's Master Plan for the Development of the Automobile Industry of October 2004.[31] More specifically, it required the local content of automobile engines to be at least 50 per cent and that of gear boxes no less than 90 per cent. For luxury vehicles, the requirement ratio is slightly lower: 20–25 per cent in 2005 rising to 40–45 per cent in 2010. Moreover, in the past, the Government used a number of non-tariff measures, such as a ban on import of products related to vehicles with right-hand-side steering wheels in 2001–2005, and an import quota for mini-buses of 16 or less seats for 1999–2000.

The protective policy, especially with the non-tariff barriers set up in the past and the tight government regulation, has been helpful in building up a local automobile industry in Viet Nam. It is not clear, however, whether this has made a long-tern difference in development because the industry is not yet efficient enough to meet international competition, and it may well be out-competed in 2006, when the protective measures are to be eliminated.

The figures on table VII.2 indicate the ratios of local content the companies promised to deliver (as set out in their licenses). Most of the FIEs have not fulfilled the obligations on the local content as prescribed in their investment licenses, nor have they cooperated to reach the targets set in the Prime Minister's decision regarding local content in automobiles. Currently, the highest ratio of LC is 33–35 per cent for trucks, while a ratio of 13 per cent is the maximum achieved in other categories of vehicles. Generally, the components and spare parts made in Viet Nam are low-end, such as battery and accumulators, tyre and inner tubes, seats, electric cables and antennas. There has so far been no specific analysis on technology transfer taking place in this industry.

Table VII.2. Commitments on localization made by automobile producers/assemblers[32]

Enterprise	Local contents (%) in years from starts of production									
	1	2	3	4	5	6	7	8	9	10
Isuzu	-	-	-	-	-	-	-	-	-	30
Mekong Auto	-	-	-	-	-	-	-	-	-	-
VMC	-	-	-	-	-	-	-	-	-	-
VIDAMCO	-	-	-	-	-	-	-	-	-	-
VinaStar	-	-	-	-	-	-	-	-	-	-
Mercedes-Benz	-	-	-	-	5	-	-	-	-	40[33]
VIDAMCO	-	-	-	-	5	-	-	-	-	35
Suzuki	-	-	22.8	-	-	29.6	-	-	-	38.2
Ford	-	-	-	-	-	-	-	-	-	30
Toyota	-	-	-	-	-	-	-	-	-	30
Hino	-	-	-	-	10	-	-	-	-	30

Source: Department of Foreign Investment, Ministry of Planning and Investment (2003).

The small domestic market for automobiles is a drawback for the realization of the localization programme. Given the diversity in car models, each containing a large number of quality components/spare parts, many highly specialized component producers are required. June 2005 data of the Ministry of Industry indicate that Viet Nam had 60 enterprises producing automobile components.[34] The supply of components and spare parts had been limited to a range of simple ones. Hence, the automobile production base is thin, and the ability to deliver at acceptable quality often insufficient. Automobile-producing enterprises share the opinion that component suppliers in Viet Nam have not been able to meet the quality standards required by the industry. Moreover, in the light of economic integration in general, and Viet Nam's WTO accession in particular, it is becoming even less attractive to invest in the production of spare parts/components necessary to meet the LCRs, as the related benefits will soon come to an end.

In 2009, Viet Nam will open its automobile market completely. So far, there is little evidence that the preferential treatment, in terms of protection given to the auto industry, has paid off. In 2005, protection remained heavy: while the tariff rates were as low as 20 per cent for CKD and 5 per cent IKD for components, the rate for imported complete automobiles was 100 per cent. Moreover, imported complete cars are subject to an excise tax of 80 per cent, while the excise tax rate on automobiles assembled in Viet Nam was as low as 40 per cent.[35] It is estimated that car prices in Viet Nam in 2004 were about 1.5 to 2 times higher than those of comparable products in the Thai market.[36] The protection mostly results in higher revenues for auto assemblers. The LCR has not proven sufficient for the development of the infant automobile industry of Viet Nam.[37] Even though it is clear that not all the auto assemblers fulfill their promises, there is no record of any penalty ever imposed on auto assemblers. That might be due either to lack of transparency or to lax law enforcement.

There might have been fewer automobile manufacturers/assemblers in Viet Nam today if the TRIMs had not been used. However, that does not mean the measures have benefited the economy, since Vietnamese consumers have had to pay much higher prices for automobiles than world market prices.

Big challenges lie ahead for Viet Nam's automobile industry. As the TRIMs elimination nears, it is likely that Viet Nam will be unable to complete the localization programme. As shown in Table VII.1, in all automobile enterprises, except VIDAMCO, State bodies have an ownership participation of 20 per cent or more. State ownership has been an important asset, but may turn into a drawback in a new business environment. Thus, a major industry restructuring is almost certain. As the surviving automakers, if any, will most probably turn out to be mostly foreign-owned, this may cast doubts on the merit of TRIMs in fostering an indigenous automobile industry.

2. Motorcycle manufacture/assembly

Manufacture and assembly of motorcycles are even more important than those of automobiles, because of the strong local demand for this product. The Government gave high priority to the development of this industry, hoping to create a production base of mechanical engineering, and thereby promote broader industrialization and modernization. The most important measures in this direction have been FDI attraction and motorcycle production localization.

Under the 1995 regulation, projects for the assembly of motorcycles in simple CKD form were not allowed. [38] The regulation also required that from the second year of production, the value of components and spare parts manufactured in Viet Nam must account for at least 5–10 per cent of the completed motorcycle cost of production, and this percentage had gradually and steadily risen to increase to reach the target of at least 60 per cent of the motorcycle cost of production after five to six years from the day of commencing production.

Another tool for achieving the localization targets is differential tariff rates, which began to be used in January 1999.[39] Table VII.3 presents the tariff rates that were applied to the products of EPZs. The rates vary by type of components/spare parts. From 20 to 55 per cent of localization, every 10 per cent increase in local content leads to a 10 per cent decrease in the tariff, thus representing a substantial incentive. Table VII.4 presents the tariff rates applied to motorcycles (manufactured in EPZs, for instance) sold in Viet Nam. In March 2003,[40] the preferential import tariff contingent upon localization ratios no longer applied to either assembling or producing motorcycle spare parts.

Table VII.3. Rate of tariff on motorcycle spare parts from EPZs (1998–2003)

Local content ratio (%)	MFN import tariff rates contingent upon localization ratios (%)			
	Spare parts subject to MFN tariff rate of 30%	Spare parts subject to MFN tariff rate of 40%	Spare parts subject to MFN tariff rate of 50%	
			Engines	Other parts
Up to 20	30	40	50	50
20 to 35	20	30	30	40
35 to 45	15	20	20	30
45 to 55	10	10	10	20
55 to 65	7	7	7	10
65 to 80	5	5	5	7
Above 80	3	3	3	5

Source: Ministry of Planning and Investment (2003).

At the time of preparing this chapter, there were seven projects involving the manufacturing and/or assembly of two-wheel motorcycles. [41] The projects were licensed over the period 1992–2001, and their total registered capital is $395 million. The ownership share of Vietnamese partners was highest in Vina-Siam (60 per cent) and lowest in VMEP (0 per cent). In all the other five – Suzuki, GMN, Honda, Yamaha and Lifan – the shares were 30 per cent for the Vietnamese and 70 per cent for the foreign partners. The contribution by the motorcycle-producing companies from Japan and Taiwan Province of China has been very important for the development of this industry.

In 2002, FIEs produced/assembled 770,000 motorcycles, which amounted to over 43 per cent of the total motorcycles purchased in Viet Nam that year. The seven FIEs had created nearly 7,500 local jobs. Moreover, they had placed orders for components and spare parts with nearly 100 Vietnamese and other FIEs, for a total value of $200 million. [42] In addition, their tax contributions have been substantial.

Table VII.4. Current rate of tariff on complete motorcycle (1998–2003)

Localization ratio (%)	MFN import tariff rates contingent on localization (%)
Up to 20	60
20 to 30	50
30 to 40	40
40 to 50	30
50 to 60	20
60 to 70	10
70 to 80	5
Above 80	3

Source: Ministry of Planning and Investment (2003).

Exports of motorcycles have been limited until recently, but there are some encouraging new developments. Honda–Viet Nam (HVN) has become a relatively big exporter. In 2004 and the first half of 2005, it shipped nearly 100,000 motorcycles to the Philippines and the Lao People's Democratic Republic. It exports motorcycle parts as well, so that its total export revenue in the first half of 2005 amounted to $67 million. Yamaha has also exported motorcycles to the ASEAN markets and is preparing to produce motorcycle parts for exports.

Unlike the FIEs in the automobile industry, the foreign motorcycle enterprises have generally delivered on their local content commitments (table VII.5). Moreover, some of the FIEs have developed production ties with Vietnamese enterprises. The most important linkages are those of HVN, by which nearly 90 per cent of spare parts produced for local market in 2004 were purchased.[43] Thanks to such business links, Viet Nam's Instrument Plant No.1 has emerged as a major supplier of motorcycle gears for HVN. Likewise, the Cong-River Diesel plant has been able to produce ball bearing sets for HVN motorcycles and others.[44] According to a report by the Ministry of Industry, the pace of localization in this industry in Viet Nam (10–15 per cent over the past two to three years) has been higher than in Thailand, which was 3 per cent per year over the past 25–30 years.

Table VII.5. Local content realization by FIE, 2003

Foreign investment enterprises	Local content (%)
Honda	64.1 to 66.1
Yamaha	48.3 to 61.3
GMN	49.7
VMEP	43.7 to 77.1
Suzuki	45.8 to 51.2
Vian-Siam	40.8
Lifan	41.2

Source: Department of Foreign Investment – Ministry of Planning and Investment (2004).

The greater local market size makes motorcycle production different from that of automobiles. Viet Nam's population of over 80 million people with limited purchasing power makes it a large motorcycle market, but a small one for automobiles. Moreover, a large part of motorcycle components made in Viet Nam are acceptable in the market, unlike in the case of automobile components. The greater demand for motorcycles makes entrepreneurs, both foreign and domestic, more likely to invest in motorcycle than in automobile parts. This is one reason for the success of the localization programme in this industry.

The elimination of TRIMs should have little effect on the operation of the FIEs in the motorcycle industry. However, many Vietnamese enterprises may be negatively affected. There are 52 enterprises currently assembling motorcycles, of which 22 are SOEs, 23 are non-State, and the remaining 7 are FIEs. A report by the Ministry of Industry predicts that after 2005, at most 10 of these Vietnamese enterprises will survive. The large supply of Chinese motorcycles will likely reduce the market share of Vietnamese producers. This development notwithstanding, the TRIMs have accomplished their objective of establishing an indigenous motorcycle industry in the country. In Viet Nam, there will be internationally-competitive suppliers, such as HVN, Yamaha and others. Even if it is unclear how many local producers will be able to export, many of them will continue to receive orders for supporting materials and parts from the major exporters.

The fact that the preferential import tariff contingent upon localization ratios has already been eliminated, that local content ratios achieved by FIEs are at least 40 per cent, and that two of them have exported suggest that TRIMs in this industry have served their purpose. The presence of foreign motorcycle producers has been essential, especially Japanese ones, which were in some way encouraged to invest and establish linkages by the use of TRIMs. In this sense, TRIMs have played a role in fostering the infant motorcycle industry locally.

3. Consumer electronic goods manufacture and assembly

Unlike the motor vehicle industry, electronics production existed in Viet Nam for some time even before the Doi Moi. Although simple electronic parts were produced back in the 1970s, a substantial industry development only took place with the establishment of the Viet Nam Electronics and Informatics Corporation (Viettronics) in 1982. In the 1980s, Viettronics was able to produce some advanced components such as printed circuit boards, several types of capacitors, etc. However, until the end of 2003, this industry remained rather small, with total investments of $1.6 billion.[45]

With the aim to assist the electronics sector, the Government has been implementing a policy of import protection. In 1995, it was compulsory for project licensing to require that assembly projects be approved only in IKD form, in which components and spare parts manufactured in Viet Nam in the first two years were to account for at least 20 per cent of the production cost of finished products, and increase in subsequent years.[46] As in other sectors, the Government later moved to use more flexible options. Tables VII.6 and VII.7 present the incentives given to producers to push them to increase the local content of their products. In the range from 20 per cent to 50 per cent, any 10 per cent produced in EPZs helped to reduce tariffs by at least 5 per cent, and the scheme works in a similar way for spare parts and complete products.

Table VII.6. Rates of tariff on electronic spare parts (since 1998)

Ratio of localization (%)	MFN import tariff rates contingent upon localization ratios (%)			
	Parts subject to MFN tariff rate of 30%	Parts subject to MFN tariff rate of 40%	Parts subject to MFN tariff rate of 50%	Parts subject to MFN tariff rate of 60%
Up to 15	20	20	30	40
15 to 30	15	15	20	20
30 to 40	10	10	10	10
40 to 50	5	5	5	5
Above 50	3	3	3	3

Source: Ministry of Planning and Investment (2003).

Table VII.7. Rates of tariff on electronic complete products (since 1998)

Ratio of localization ratio (%)	MFN import tariff rates contingent upon localization ratios (%)			
	Parts subject to MFN tariff rate of 30%	Parts subject to MFN tariff rate of 40%	Parts subject to MFN tariff rate of 50%	Parts subject to MFN tariff rate of 60%
Up to 20	20	30	40	40
20 to 35	15	20	30	30
35 to 50	10	10	15	15
50 to 60	5	5	10	10
Above 60	3	3	3	3

Source: Ministry of Planning and Investment (2003).

Despite the substantial incentive created, the effectiveness of the local content-promoting measures has been low. Until recently, there was no significant production of components in Viet Nam. A small number of enterprises producing electronic components and spare parts (such as Daewoo-Hanel Hong Viet, Daewoo-Viettronics, etc.) have been assembling imported components to make final components or performing simple tasks. Because the operations are simple, enterprises from many countries compete for orders, driving the value added down. There are some high-tech products, such as picture tubes by Orion-Hanel and the Printed Circuit Boards by Fujitsu, the latter also producing hard disks. As of 2004, Fujitsu and Orion Hanel alone generated 95 per cent of Viet Nam's total exports of electronics. However, the local content is very low in products exported. For instance, over $500 million of Fujitsu's $600 million in export value was accounted for by imports of intermediates.[47] This means that little value was added in Viet Nam. A report to the Ministry of Trade revealed that Viet Nam's imports of intermediate electronic goods in 2004 exceeded the export revenues of this sector.[48]

The Government has recognized the importance of promoting this sector and one of the chosen measures is to attract FDI. At the end of 2004, 22 FIEs operated in Viet Nam, with a total registered capital of $615 million. Products include televisions, cassette players, radios, video players, video cassette recorders, computers, refrigerators, air conditioners, television picture tubes, and electronic components/spare parts.

Viet Nam does not possess substantial advantages in the production of consumer electronics, compared to other countries, such as China or Thailand. There is also a risk that the currently strong exporters of consumer electronics will move to Thailand or other countries when Viet Nam joins WTO and substantially reduces protective measures. In the foreseeable future, Vietnamese electronic enterprises will still be dependent on foreign partners for product designs, technologies and even distribution channels. The market share of the domestic enterprises operating in Viet Nam shrank rapidly when the tariff on complete consumer electronics was recently reduced in accordance with the implementation roadmap of the ASEAN Free Trade Agreement. The challenges to Vietnamese electronic enterprises will be severe. That is, however, not entirely because of the TRIMs elimination, but mainly because of the removal of import protection.

The TRIMs (e.g. LCRs and preferential tariff and tax rates contingent on localization) played a certain role in bringing in foreign manufactures of consumer electronics and therefore, created employment and raised exports. However, the transfer of knowledge has been much smaller than expected, and therefore growth in this industry may be vulnerable to changes in the regulatory framework. Meanwhile, as a result of the TRIMs, Vietnamese consumers have had to pay higher prices for, or face the limited quality of, the electronic products they purchase.

4. Milk processing

Due to its large market potential, milk production in Viet Nam promises lucrative investment opportunities. Moreover, the development of this industry would help to boost husbandry, which has been very encouraging in terms of rural employment and poverty reduction. From this perspective, the development of milk production is promoted by the Government.

The rate of economic growth has been high in the past decade and a half, and the demand for milk products has increased even faster. Nearly 30 enterprises operating in this industry have made substantial progress in

acquiring modern technologies and equipment, improved their coordination with cow-rearing farms aiming at the expansion of local supply of raw materials. A report by the Ministry of Planning and Investment indicated that, in the past decade, milk production grew annually at between 8 and 12 per cent. In 2004, there was a cow population of about 56,000. The majority of cow-rearing households are around Ho Chi Minh City and Ha Noi, where the opportunity costs of grazing are obviously high. At the same time, there are areas elsewhere with unused comparative advantages.

Import substitution has been a major policy strategy in this sector. As guidelines to the implementation of the LFI, Government Decree No. 27 of March 2003 stipulated that projects in dairy production and processing are required to include investment in development of raw material sources. The regulation applies to all projects, regardless of whether the outputs are to be sold domestically or exported. The biggest programme in this area relates to the development of the cow population over 2001–2010.[49] The Prime Minister's decision emphasizes the importance of local provision of raw materials and the gradual increase of export and decrease of import. Particularly, the decision requires that "the factories for milk processing be based in areas with concentration of grazing farms" so that "Viet Nam will be, by 2010, able to supply 40 per cent of domestic demand in fresh milk from domestic cow population". This target serves as a guideline in the consideration of foreign investment projects in this sector.

As of the end of 2004, there were nine FIEs active in milk processing or in operation related to milk products. Total registered capital of the FIEs is $160 million. Four of them were 100 per cent FIEs from Hong Kong (China), Taiwan Province of China, Australia and the United States. The others were joint ventures with partners from Taiwan Province of China, Hong Kong (China), New Zealand and the Netherlands. Even though the FIEs have a 25 per cent market share, only four of them have sub-projects in the development of cow population for supply of raw materials. The FIEs mainly use imported raw milk materials or purchase them from independent households. Growth rates of cow population have been lower than of milk production and the operations of FIEs have led to increased imports of milk materials.

Currently, domestic supply accounts for 95 per cent of the final milk product market. Viet Nam exports small amounts of milk products to the Middle East, Japan, the United States and China. The price of Vietnamese milk is currently about 17 per cent higher than the world average[50] and milk-processing enterprises therefore import such inputs, even if this goes against the raw materials localization policy. In practice, the recent trend for the industry has been to import 90 to 95 per cent of raw milk materials to a value of $80 million to $100 million per year.[51] Even though not all FIEs have followed the requirements, no action has been taken against the importation of milk materials.

If Viet Nam had a comparative advantage in the production of raw milk materials, it should have emerged over the past decade, when measures were taken to encourage the development of the cow population. There is no evidence of either high productivity or good quality of large-scale raw milk materials production. Imports of raw material have been necessary. Thus, there may be little rationale for maintaining the LCRs. The elimination of such TRIMs may make the milk production easier, thus helping to cut cost and prices of milk products in the domestic market.

5. Cane sugar processing

The cane sugar industry in Viet Nam is not internationally competitive, but the

Government has tried to protect it mainly for employment purposes. In fact, in certain areas, the best use of land has been to grow sugar cane. However, production has been household-based and the resulting supply has never been suitable for large-scale production. Cane supply fluctuates widely in relation to price and weather changes. In the 1990s, investors in cane sugar production were required to commit to develop local raw material sources for sugar production. Even though the requirement was later eliminated, the development of cane supply by FIEs has always been prioritized in project approvals. Moreover, to protect the domestic sugar industry, the Government increased the rate of tariffs on sugar from 10 per cent in 1992 to 45 per cent in 1999, and quotas also applied. Sugar imports are still virtually banned, except in special situations, when the Prime Minister considers it necessary.

However, for a number of reasons – such as harvest uncertainty, bad weather or poor planning – shortages in cane supply have been negatively affecting sugar mills in Viet Nam. Mills often operate below capacity, sometimes at small fractions of their capacity. Costs of local raw material are high, leading to big differences between world and domestic prices of sugar.[52] The price gap has led to massive sugar smuggling from neighbouring countries, such as Thailand (through Cambodia) rendering the high tariff policy ineffective.

As SOEs dominate the production, profit-making was not the driving force in the Government's "One-Million-Ton-Sugar Programme" that began in 1995 and resulted in 32 new mills being built at a cost of $750 million, with an additional $350 million put into infrastructure in sugar regions (Dapice, 2003). As a consequence, Viet Nam now has 42 sugar mills, of which 15 are central SOEs, 23 are provincial SOEs, two are joint ventures with FIEs and the remaining two are fully foreign owned. Total registered capital of the four FIEs is about $164 million.[53]

A report by the Vietnamese Association of Cane Sugar Producers in July 2003 revealed that 15 of the 42 sugar mills were experiencing large losses.[54] Most of the members in the Association are SOEs, which enjoy protection. Permission to import has been granted only in times of excess demand, when the domestic price of sugar was higher than what the Government believed to be reasonable. Meanwhile, the two fully FIEs make a profit.

Government Decree No. 27 of March 2003 regulates that projects in cane sugar are required to include investment in the development of cane supply. This requirement, together with import control and the tolerance of loss-making SOEs, are actions taken for employment protection reasons. None appears to have promoted the overall efficiency of the economy. For example, the cost of domestic raw material is higher than that of the after-tariff raw sugar imported from the Russian Federation. Domestic mills sometimes have difficulty covering their costs when the price comes near to import parity, because of smuggling or market saturation (Dapice, 2003). In other cases, consumers bear the burden of the high price of sugar. Looking ahead, the removal of quotas on sugar importation will be a serious challenge to many of the sugar mills, and it is expected that only a fraction of Vietnamese sugar mills can survive international competition. If the industry is fully opened to competition, it will have to undergo a period of restructuring with ownership changes, and increased importation of either raw or refined sugar. Experts generally seem to agree that the Government's "One-Million-Ton-Sugar Programme" has failed.

6. Vegetable oil processing

Producers of vegetable oils in Viet Nam use raw materials, such as groundnuts, sesame seeds, coconuts, etc. The industry has a certain potential for development, but growth has so far been low, at an average of 3

per cent per year. Local products currently supply about 95 per cent of the market and can be exported. FIEs have been playing an important role in the development of this industry. The Government has licensed five foreign investment projects, with a total of $77 million in registered capital. Three of the FIEs are 100 per cent foreign owned, and two are joint ventures. The foreign partners are from Malaysia, the Republic of Korea, Singapore and Taiwan Province of China.

The Government's Decree No. 27 of March 2003 provides that foreign-invested projects in vegetable oil include investment in the development of raw material sources for their input. The scales of such investment in raw material sources are often for the investment authorities to decide and the localization policy is not effectively implemented. Enterprises in this industry import most of the raw materials needed for their production. A calculation in a recent report by the Ministry of Industry revealed that by 2005, local raw materials were able to meet only 14 to 15 per cent of the industry's demand and that, for 2010, that ratio is estimated to be in the range of 18 to 33 per cent. [55] Local supply for commercial production of vegetable oils is insufficient in both quantity and quality, also due to natural conditions. At the current scale, which is larger than in the past, there is little evidence of any comparative advantage in the production of raw materials for vegetable oil processing. Thus, regulations on the development of local input supply have not been very helpful. The effect of full trade liberalization on the production of vegetable oils should be small.

7. Wood processing

Unlike in the industries analyzed above, Viet Nam possesses a certain comparative advantage in the manufacture of wood products. Traditional handicraft can be an important factor in this industry. While large capital investments are not essential, there is ample availability of human capital. In fact, wood products are among the top earners of foreign exchange for Viet Nam. The sector is attractive to foreign investors and there are as many as 225 FIEs currently operating in Viet Nam. The total registered capital of the FIEs is $765 million.[56] A large number of the foreign investors in wood processing come from Taiwan Province of China, with others coming from Australia, Malaysia, New Zealand, Singapore, Japan and the Republic of Korea. As the data imply, the projects are typically small.

More than in other industries, wood production is sensitive in terms of environmental considerations. The local content regulation for this industry can be found in Government Decree No. 27 of March 2003, which requires that wood processing projects (except for projects using imported wood) include investment in development of raw material sources. However, the regulation has not been enforced strictly and the FIEs have not entirely fulfilled their obligations. Afforestation regulations are difficult to implement by individual enterprises, which are generally small, while forest development needs to be carried out on a large scale. In such cases, free riding can be a problem.

Having recognized the reality, the Government has let enterprises import wood materials as inputs, with cost savings as a result. Nowadays, wood-processing FIEs, particularly those in the south of Viet Nam, use mostly imported wood for their export production. Only a fraction of their inputs are the products of local afforestation.

Thus, while the afforestation regulation may seem appealing, it has not been easy to enforce in practice. The requirement has increasingly been ignored, and therefore its elimination, if necessary, will not make a significant difference. The Government can liberalize wood trade (wood import and wood products for export) and

enforce strict forest protection measures, which apply to all economic agents. There could also be reasonable taxes on exported wood products, so that tax revenue can be used for forest protection.

E. Conclusions

The TRIMs used in Viet Nam were intended to contribute to the modernization of the economy, increased foreign exchange reserves, more employment and a more efficient use of local resources. Some of the measures employed belong to the list of WTO prohibited TRIMs. The application of TRIMs over the past decade and a half resulted in considerable drawbacks and, at the same time, moderate benefits. The effects of TRIMs are significant only for a small group of industries, and often only temporary in nature. The limited positive effects will likely disappear when Viet Nam removes the TRIMs as a result of WTO accession.

The implementation of TRIMs in Viet Nam can give the impression that they have been helpful in achieving policy targets. In substance, however, the merits of TRIMs may have been overrated. For instance, FIEs have increased exports of electronic goods and that is often considered positively. Major electronic exporters are isolated from the rest of the economy as they import nearly all their inputs and export all of their outputs, contributing few positive production externalities to the local economy. In addition, the high growth rates of exports have happened mainly in labour-intensive industries, which are often competitive even without a foreign presence, thus leading to caution against overestimating the FIEs' role in export performance.

There are several reasons for the limited FDI spillover effects. Firstly, there is a lack of local human resources capable of assimilate advanced technologies. Secondly, the wage gap has limited movements of employees from FIEs to domestic enterprises. Thirdly, stiff competition limits the willingness of foreign investors in sharing proprietary knowledge, especially when intellectual property rights are poorly managed. Finally, the insufficient financial strength of local enterprises, which are mostly small or medium-sized firms, prevents them from acquiring both expensive advanced technology and the necessary skills and absorptive capacity.[57]

The much smaller gap between domestic and foreign motorcycle firms helps to explain the difference between the performances of TRIMs in the motorcycle as compared, for instance, to the automobile industry. The gap between Viet Nam and neighbouring countries in terms of e.g. the technology-production base and human capital relevant to motorcycle production is relatively smaller than that related to the production of automobiles. In addition, the market for motorcycles is much larger than for cars. For the motorcycle industry, TRIMs have in the main already served their purpose and local content levels as high as 60 to 70 per cent have been achieved. Hence, some of the motorcycle producers are now basically ready for competition under WTO rules. While the impact of the elimination of TRIMs is likely to be adverse for Vietnamese enterprises in automobile and the consumer electronic industries, it should not be a serious problem for the motorcycle producers in Viet Nam.

The regulation on the obligation in the development of local raw materials has certainly been a drawback for foreign investors, even though it has not been fully implemented. Viet Nam does not have comparative advantages in the production of raw materials of milk, sugar and vegetable oil products. Given the ineffectiveness of existing measures, their elimination will make little difference for the production of vegetable oils, milk and wood products. For sugar cane, however, the application of LCRs, together with other measures of

protection, has led to a problematic situation. Nearly a decade after the adoption of the regulation, shortages of cane supply have been chronic. High costs of local raw material lead to substantial differences between world and domestic prices of sugar. Evidently, the requirement on development of local supply of canes failed, and the removal of the TRIMs and other measures of protection can be expected to cause disruptions for the sugar industry. Major ownership changes are expected to take place in sugar mills of Viet Nam as a result.

Viet Nam has unilaterally abandoned many TRIMs and the Government has generally not punished enterprises failing to conform to some others. Insufficient feasibility has been part of the policymakers' failure, behind which there are many factors, such as weaknesses in the system of law enforcement, a weakly developed industrial base, insufficient human capital and poor natural conditions for certain types of production. The experience of Viet Nam over the last decade suggests that most TRIMs have not been very helpful. Only in certain conditions has protection of infant industry worked. One conclusion is that the gap between the development level of local industry being protected and that of the world must not be too wide.

There are alternative measures that are WTO-compliant and at the same time may be helpful for achieving the Government's objectives. With respect to the automobile, motorcycle and electronic industries, the Government has outlined a plan for the provision of further incentives to attract FDI in projects aimed at the production of supporting materials. These projects may boost local production of high-quality components and spare parts. Accordingly, small and medium-sized domestic enterprises in these industries would also be the recipients of various kinds of incentives. The Government is also contemplating setting up special industrial zones for both domestic and foreign enterprises producing supporting materials and components for these industries.

Local production of certain raw materials can be made more competitive. One of the supporting measures is to provide incentives to attract FIEs that use advanced biotechnology for production of new plant varieties that lead to higher economic efficiency. Investment measures for the sustainable development of raw material production may include the supply of funds for development of infrastructure, provision of favourable credit for farmers and other partners engaging in raw material development and provision of better services such as information on production techniques. It may be acceptable to apply moderate tariffs on raw sugar and milk powder to protect these industries for some period of transition. And privatization of State sugar mills and milk factories may be necessary for the improvement of the industries' competitiveness.

Annex to chapter VII. Additional tables

Preferential tariff rates contingent upon localization ratios with respect to products and parts of mechanical/electric/electronic industries (since 1998)

Table A.VII.1. Mechanical-electric complete products

Localization ratio (%)	MFN import tariff rates contingent upon localization ratios (%)			
	Parts subject to MFN tariff rate of 30%	Parts subject to MFN tariff rate of 40%	Parts subject to MFN tariff rate of 50%	Parts subject to MFN tariff rate of 60%
Up to 20	20	30	40	50
20 to 35	15	20	30	40
35 to 50	10	10	20	20
50 to 60	5	5	10	10
Above 60	3	3	3	3

Source: Ministry of Planning and Investment (2003).

Table A.VII.2. Mechanical/electric parts

Achieved localization ratio (%)	MFN import tariff rates contingent upon localization ratios (%)			
	Parts subject to MFN tariff rate of 30%	Parts subject to MFN tariff rate of 40%	Parts subject to MFN tariff rate of 50%	Parts subject to MFN tariff rate of 60%
Up to 15	20	20	30	40
15 to 30	15	15	20	20
30 to 40	10	10	10	10
40 to 50	5	5	5	5
Above 50	3	3	3	3

Source: Ministry of Planning and Investment (2003).

Notes

1 This chapter is based on a paper prepared for UNCTAD by Duc and Hung (2006).

2 These are the State-owned enterprises and the shortage of cane supply is reported to be the main reason for their losses.

3 The discussion is not intended to provide any detailed legal analysis of individual measures.

4 With the united Investment Law that came into effect on 1 July 2006, foreign investment is governed by the same law as domestic investment.

5 For example, a rate of 15 per cent for the first 12 years of operation, with "grace periods" (zero rate in first two profitable years and 50 per cent reduced income tax rate over the three following years), is applied to certain types of projects. The first group consists of projects employing labour intensively and using the abundant natural resources effectively. The second group consists of those exporting 30 per cent or more of their output and using domestically-sourced inputs amounting to 30 per cent or more of the cost of production.

6 A more detailed description of some such conditions is given in section C.

7 In 2003, the Government issued Decree 38 on the transformation of part of the FIEs into joint-stock companies.

8 In this period, programmes of localization and development of local resources of raw materials were not required, but served to increase the chances of being licensed and, if approved, to qualify for preferential treatment in terms of lower corporate income tax.

9 Legally, Circular 215 had expired because it served as a guideline to Government Decree 18/CP, which was subsequently replaced by two other Government Decrees: 12/CP of 1997 and 24 of 2000. However, in practice, it remains in use in licensing procedures.

10 These requirements remain on the list of conditional sectors for investment. The list is an annex to the Government Decree 24 of July 2000, and Decree 27 of March 2003, which guide the application of the LFI in Viet Nam.

11 In the regulation, the percentage values of products, components or spare parts are based on cost of production. For the values of intermediate goods, the CIF price is applied for imported goods, while, value added taxes are excluded if the intermediate goods are purchased domestically.

12 By Government Decision No. 27/2003/NĐ-CP of March 2003.

13 See Circular 176/1998/TTLT-BTC-BCN-TCHQ.

14 See Ministry of Trade (2003).

15 See "Higher Tariff Makes It More Difficult for the Automobile Industry", *VietNamNet* 08/11/2003.

16 See Government Decree 45 of 2000, and Inter-ministerial Circular 20 of 2000.

17 For instance, there was a requirement that total imports of consumption goods should not exceed 20 per cent of the total value of export.

18 Viet NamNet, 2 January 2005.

19 According to some experts, clinker imports are based on decisions of the Ministry of Construction. However, consultations with VNCC are always necessary.

20 See article 71 of the Government Decree No. 24 of year 2000.

21 See article 6 of the Government Decree No. 170 of year 2003.

22 There remain regulations listing prohibited items, locations not to be mined for export, as well as the conditions for mineral export license.

23 Viet Nam News, 27 February.

24 The foreign investors without technological strength, foreseeing difficulty in meeting the obligations, would choose not to enter.

25 See Ministry of Planning and Investment's Circular No. 229 of April 1998.

26 The list includes (a) cement production; (b) paints and construction paints; (c) toiletry tiles and ceramics; (d) PVC and other plastics; (e) footwear; (f) clothing; (g) construction steel; (h) detergent powder; (i) tires and inner tubes for automobile and motor bikes; (j) NPK fertilizer; (k) alcoholic products; (l) tobacco; and (m) papers, including printing, writing and photocopy paper). Such requirements may be maintained for up to seven years from the entry into force of the BTA.

27 According to Decision 718 by the Ministry of Planning and Investment, Viet Nam had an 80 per cent export requirement for (a) motorcycles, minibuses and trucks (less than 10 ton); (b) some irrigating pumps; (c) medium-voltage, low-voltage and normal electric transmission cables; (d) cargo ships; (e) audio-visual products; (f) aluminium profiles products; (g) construction glass; (h) NPK fertilizers; (i) PVC; (j) bicycles and bicycle parts; (k) transformers under 35 KV; and (l) diesel motors under 15 CV. This was not entirely a progress in the direction of liberalization, as some of the products identified in Decision 718 were not in the list agreed upon in the BTA.

28 Ministry of Finance, unpublished reports.

29 Not counting Chrysler which left.

30 Prime Minister Decision No. 175 of 2002.

31 Prime Minister Decision No. 177 of 2004.

[32] For the enterprises which were licensed before 1994, the regulation on local content does not apply.

[33] In the case of Mercedes-Benz, the period is 15 years.

[34] Ministry of Industry, unpublished report (2005).

[35] The newly approved tax law establishes that from 1 January 2006, excise taxes of 50 per cent will be applied to both imported and domestically produced cars. For vans and mini-buses, the rates will be 30 per cent and 15 per cent, respectively.

[36] Viet NamNet, 19/11/2004.

[37] The President of Viet Nam Automobile Manufacturers' Association, Sasagawa Makoto, said that the regulation on local content is not a correct orientation for the industry (VNExpress 26/11/2004).

[38] Circular No.215UB/LXT.

[39] Inter-Ministerial Circular No. 176, December 1998.

[40] By Government Decision 27 March 2003.

[41] One license was revoked in 2002 and is not counted here.

[42] Data of the Department of Foreign Investment – Ministry of Planning and Investment, 2003.

[43] Ministry of Industry, News online, 14 July 2005.

[44] Nhan Dan Newspaper, 1 June 2005.

[45] Unpublished report by the Viet Nam Electronic Industries Association (VEIA).

[46] State Committee for Cooperation and Investment Circular 215 of 1995.

[47] Estimation by the Viet Nam Electronic Industries Association based on 2003 data.

[48] Much of the intermediate good is used for the production of locally consumed products; see Ministry of Foreign Affairs News 10/6/2005.

[49] Prime Minister's Decision 167 of October 2001.

[50] Viet NamNet 15/5/2005.

[51] Unpublished report by the Department of Industry, Ministry of Planning and Investment (2004).

[52] For instance, in early September 2005, a kilogram of sugar sold in Ho Chi Minh City for VND 9,000, while the price at the Viet Nam-Cambodia border was VND 6,000. See "Sugar smuggling increase dramatically as domestic price high". VietNamNet 9 September 2005.

[53] Unpublished report by the Department of Foreign Investment, Ministry of Planning and Investment (2004).

[54] *Viet Nam Economy*, 11 April 2005.

[55] "Development Plan for Vegetable Oil Industry to 2010". Report by Ministry of Planning and Investment, Viet Nam Industry, 7 November 2004.

[56] Unpublished report by Department of Foreign Investment, Ministry of Planning and Investment.

[57] In fact, Vietnamese enterprises are often not very interested in technology. A survey of 41,000 enterprises located in Northern provinces of Viet Nam, conducted by Ministry of Planning and Investment in 2005, indicates that only 26 per cent of the surveyed enterprises have any interest in information on new technologies.

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Interviews (chapter II)

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- Fernando Porta, Centro REDES.
- Luis Katz, Ministry of Economy.
- Nicolás Cacace, Association of Auto-Parts Manufacturers (AFAC).

Interviews (chapter V)

Beth Lee, President, Chamber of Automotive Manufacturers of the Philippines, Inc. (CAMPI)

Homer Maranan, Executive Director, CAMPI.

Frank Mero, President, Automotive Industry Workers Alliance (AIWA).

Officials of the Bureau of International Trade Relations, Department of Trade and Industry, and Motor Vehicle Products Division, Board of Investments, Department of Trade and Industry.

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