



**Asia-Pacific  
Economic Cooperation**

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# **The Links Between Trade, Investment and Structural Reform**

**Document: 2008/SRMM/ 013  
Ministerial Meeting on Structural Reform  
Melbourne, Australia  
3-5 August 2008**

**APEC Policy Support Unit  
August 2008**

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APEC#209-SE-01.3



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# **The Links Between Trade, Investment and Structural Reform**

Background Paper

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## Executive summary

Trade reforms such as liberalising tariffs and structural reform like competition policy are respectively examples of at-the-border and behind-the-border policy reforms. When both sets of reform are focused on economic efficiency, domestic growth and citizen wellbeing are increased. Both sets of policies also enhance an economy's ability to trade and invest with the rest of the world and to reap greater benefits from doing so.

In light of this, well developed sets of both policies can provide greater benefits if pursued together. Openness to trade and foreign direct investment (FDI) leads to opportunities, not guarantees, which may not be realised if behind-the-border policies do not support competition and efficiency. Gains from behind-the-border reforms increase significantly in an economy that can leverage global opportunities.

The need for coherence between at-the-border and behind-the-border reforms is growing as the spread of global supply networks, just-in-time production and the internationalisation of services changes the nature of global production, trade and investment. The reforms can be viewed as public policy inputs to global supply chains which aim to benefit both producers and consumers.

However, tensions may arise between behind-the-border and at-the-border policies when they depart from their main purpose of economic efficiency and pursue other objectives, or when policymakers do not share the same view of economic efficiency.

In the last two decades, many economies have reformed both their at-the-border and behind-the-border policies, at various paces and to different degrees. This trend provides numerous case studies and broader empirical evidence that support the view that there are strong mutually reinforcing links between at-the-border and behind-the-border policies.

While behind-the-border reform is becoming more important for growth and regional integration, there are particular sensitivities and challenges to international efforts to promote reform of behind-the-border policies. As such, APEC's wide membership, its focus on voluntary, non-binding actions and its non-negotiating nature, means it is a uniquely useful forum in which to explore links between at-the-border and behind-the-border barriers, and promote sound reforms to both enhance prosperity and regional integration.

## Introduction

1. APEC's focus on regional prosperity and integration in an era of rapid globalisation has led to an agenda of behind-the-border as well as at-the-border reforms.
2. At-the-border reform focuses on measures that overtly discriminate against foreign goods, services and investments such as tariffs, national content requirements and restrictions on foreign equity.
3. Behind-the-border or structural reform consists of improvements made to institutional frameworks, regulations and government policy so that barriers to regional economic integration and improved economic performance are minimised. Behind-the-border barriers come in many forms such as excessive regulation, poor legal infrastructure and unclear property rights and the lack of effective laws to foster competition.
4. Structural reform helps foster an environment that supports the efficient functioning of markets, contributes to macroeconomic stability, productivity and economic growth. Removing impediments and shaping incentives for firms to become more productive, ultimately leads to a higher standard of living through higher real wages and more attractive returns on capital.
5. Properly designed, both sets of policies have the same goal of greater efficiency and there are strong links between them. This paper examines these links and underlines the need for coherence between both sets of policy approaches.

## How are these policies related?

6. Reforms at-the-border and behind-the-border with the same overarching goal of enhancing efficiency and growth can work to reinforce the potential benefits of each other. Behind-the-border reforms are beneficial to trade and investment flows; they also increase gains from trade and investment liberalisation. At-the-border reforms encourage exposure to best-practice international benchmarks which drive greater efficiency and competitiveness in an economy.

## Impact of behind-the-border reforms on trade and investment flows

7. Behind-the-border reforms have a substantial impact on trade and investment by influencing the relative prices of different products and the relative rates of return expected from investing in different locations. There are three main channels for this:
  - Reducing unnecessary costs for producers, exporters and importers. For example, two-way trade and investment with an economy that has eliminated excessive regulation, reduced processing delays or simplified complex licensing procedures can be more beneficial.
  - Reducing risk. Clarifying legal enforcement of contracts or increasing the predictability of government policy provides greater certainty, increasing incentives for two-way trade and investment.
  - Enhancing ease of entry into markets generating more opportunities for domestic and foreign firms to trade and invest.

8. Poor structural policies can act to restrict the level of trade and investment flows that would otherwise occur as a result of progress in trade and investment liberalisation. Hence, behind-the-border reform is vital to driving genuine regional and global economic integration.

### **Gains from trade and behind-the-border reforms**

9. Gains from trade reforms are generally divided into two categories: static and dynamic gains. Static or one-off gains result from a better allocation of existing resources and the take-up of slack in the usage of resources. Dynamic or ongoing gains arise from greater efforts to innovate and optimise production and the more rapid diffusion of new technologies.

10. Static gains are strongly influenced by behind-the-border conditions. When trade liberalisation occurs, this results in higher relative prices, wages and capital returns in sectors where there is a comparative advantage. This attracts entrepreneurship, labour, and capital to those sectors.

11. To ensure an economy benefits overall from this better allocation of resources, domestic markets need to function well. They need to be open to competition, unhindered by over complex regulations, supported by good governance and sound legal and economic infrastructure. If a sector is dominated by a domestic monopoly, for example, this can prevent the reallocation of resources towards the more efficient sectors, channelling the gains from trade liberalisation into monopoly rents.

12. Longer-term or dynamic gains from trade are also strongly influenced by behind-the-border conditions. When domestic markets are exposed to greater competition the most productive firms thrive and the less productive firms must improve their competitiveness to survive. This leads to an increase in the average productivity of sectors opened to foreign competition. In addition, continuous exposure to competition spurs firms to increase their productivity and reduce their costs by eliminating inefficiencies, sourcing their inputs from more efficient producers and optimising their scale of production. Moreover, greater competition drives technology transfer, innovation and technology diffusion.

13. Opening a domestic market to trade and investment increases its potential exposure to competition and behind-the-border policies need to be such that this potential can be realised. This requires good competition policy, adequate governance and legal and economic infrastructure, including intellectual property rights to protect and support innovation.

14. The two-way links between at-the-border policies and behind-the-border policies are enablers for firms to become more successful global traders.

### **Gains from foreign direct investment and behind-the-border reform**

15. As with trade, the impact of behind-the border reforms on the gains from foreign direct investment (FDI) for an economy are potentially significant and positive.

16. FDI which brings in new capital, interacts with domestic companies and shares technology, know-how and contacts benefits an economy the most. The benefits of FDI to an economy are also strongly influenced by the openness to competition in it. FDI is

least beneficial when it is 'tariff-jumping', that is, it is attracted to those sectors that combine border protection and behind-the-border conditions that encourage monopolies.

17. When an economy has implemented structural reform policies<sup>1</sup> that promote competitive, well-functioning markets, new FDI is more likely to be efficiency-seeking; that is, the foreign firm is investing in the local economy to take advantage of lower cost structures. Through a more efficient allocation of resources this has more potential productivity spillovers for the domestic economy than tariff-jumping foreign investment.

18. When FDI is efficiency-seeking this can lead to the emergence of an 'FDI-trade nexus' – a mutually reinforcing process of trade and FDI flows. The nexus between FDI and trade has been particularly evident in East Asia. East Asian economies have seen a rapid expansion of both FDI and FDI-induced manufactured trade.<sup>2</sup>

19. This has contributed to the rapid growth of trade and investment in the APEC region. APEC's exports and imports of goods and services increased at an average annual rate of 10 per cent over 1990-2007 to reach US\$8,328 billion and US\$8,579 billion in 2007 respectively. APEC's exports and imports accounted for over 40 per cent of world trade. The stock of APEC inward and outward FDI continued to expand at an average rate of 12 per cent between 1990 to 2006 to reach US\$4,704 billion and US\$4,836 billion respectively at the end of 2006. This accounted for around 40 per cent of both the global inward and outward FDI stocks.

## The changing nature of world production, trade and investment

20. International trade and FDI have been growing faster than output over the last two decades reflecting the increasing internationalisation of world production: firms are increasingly using organisational strategies that see their production take place in different economies through global supply networks.

21. Economies that want to fully reap the benefits of integrating into this rapidly evolving global environment need to make both at-the-border and behind-the-border reforms. Globally focussed firms will be attracted to markets that are open and also where the cost and risk of doing business is the lowest. They will engage more with local firms, spreading their technology and skills more widely, if the local firms are more competitive. Hence the significance of a coherent approach to both at-the-border and behind-the-border reform for trade, investment and growth is growing.

## A two-way relationship in policy reform

22. The relationship between at-the-border reform and behind-the-border reforms also goes the other way. For example, trade and investment liberalisation can reinforce the pro-competitive impacts of introducing good competition policy. The depth of competitiveness of domestic markets will be strengthened by the entry of domestic and foreign firms.

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1 In an APEC context, structural reform refers to five priority work streams targeting regulatory reform, competition policy, public sector governance, corporate governance and strengthening economic and legal infrastructure and form part of the Leaders' Agenda to Implement Structural Reform or 'LAISR').

2 Kawai, M 'Trade and Investment Integration for Development in East Asia: A Case for the Trade-FDI Nexus', ABCDE Europe Meeting, Brussels, 10-11 May, 2004.

23. Adherence to commitments under international trade and investment agreements that embody rule-based disciplines can strengthen good governance across the public and corporate sectors. They can curb incentives and opportunities for public policy officials, as well as business, to engage in discretionary behaviour and corrupt practices.

24. Trade and investment openness is also significantly associated with a greater likelihood of transitions to greater institutional quality and more pro-competitive behind-the-border policies. The pro-liberalisation lobby has grown to counter the pro-protection lobby. Greater openness allows a greater role for export sectors that are not seeking government subsidies or protection. Firms in these export sectors will be required to lower costs and continuously innovate to stay globally competitive and this should create momentum for behind-the-border reforms.

## Potential conflicts

25. Possible conflicts between at-the-border and behind-the-border policy reform can arise, for example, because of supplementary objectives beyond economic efficiency. These can be objectives like alleviating poverty and the mitigation of adverse effects from economic change on specific groups of the population. Delivery mechanisms to achieve these objectives are sometimes not fully compatible with economic efficiency.

26. Tensions may also appear between the policies when objectives are not broadly based. For example, a prohibition on mergers and the retention of monopolies can reduce market access to foreign participants. Another example is the conflict between certain types of incentives given to companies to attract their investments. Some of these incentives could have a trade-distorting effect and may conflict with an economy's obligations under trade agreements.

## Where is the evidence?

27. Over the two last decades, both developed and developing economies have moved at different paces towards more open economies and implementing behind-the-border reforms. This has happened at different paces and in various ways, providing examples of where combining these two sets of policies can reinforce benefits and, conversely where failing to combine them has blocked gains. These experiences strongly suggest that economies who undertake structural reform in conjunction with trade liberalisation are able to maximise the economic gains from trade reform.

28. In the late 1980s, **Australia** commenced extensive at-the-border policy reform that saw tariffs for most industry sectors falling to five per cent or less by 1996. This gave rise to pressure in the business sector for lower cost levels and resulted in behind-the-border reforms to improve labour market flexibility, lower energy costs, improve competition laws and corporate regulation and put more incentives into the taxation system. Early analysis showed that although trade liberalisation alone would have reduced manufacturing employment by 0.3 per cent, reforms across all the areas would have increased employment in the manufacturing sector by 1.3 per cent.<sup>3</sup> Later modeling of the impact of behind-the-border reforms undertaken over the decade from

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3 Banks, Gary 2005, 'Structural reform Australian-style: lessons for others?', Productivity Commission, Canberra.

the late 1980s indicated Australia's real GDP was projected to be around 2.5 per cent (or A\$20 billion) higher compared to a 'no change' base case.<sup>4</sup>

29. As an example, **China's** entry into the World Trade Organisation (WTO) in 2001 not only created greater openness and competitiveness in its economy; it also made the policy environment for traders and investors more predictable. This coupled with ongoing structural reforms since entry has contributed to rapid growth in Chinese exports and inward FDI. Resulting real GDP growth rates have been in excess of 10 per cent during the past four years, and 11.4 per cent in 2007, the fastest pace in 13 years. In 2007 China was a major recipient of FDI, much of it in export-oriented industries. The importance of inward FDI to the Chinese economy can be gauged by its FDI as a share of GDP, which was nearly 21 per cent in 2006.<sup>5</sup>

30. **Korea's** experience showed that trade liberalisation does not automatically lead to a more competitive domestic market, and that better outcomes are achieved when trade and investment liberalisation is accompanied by measures to increase competition. In the late 1990s, Korea's interest in promoting more vigorous competition and improving corporate governance followed from the perception that incumbent firms had in the past taken too much advantage of their substantial market positions, with little or no offsetting benefits. Curbing the power of the large conglomerates or 'chaebol' became a policy priority after the 1997–1998 financial crisis. Many commentators conclude that the crisis was aggravated by the market dominance of the chaebol.

31. Trade liberalisation created domestic pressures for tackling other behind-the-border issues in **Mexico**. It compelled business associations to lobby the government for reforms aimed at reducing regulatory red tape.

32. The **New Zealand** economy experienced intensive macroeconomic and structural reform during the second half of the 1980s and the early 1990s. Economic growth immediately following the launch of reforms was disappointing causing debate about whether reforms were properly coordinated and sequenced. However, in the longer term, the economy's growth performance improved significantly. The economy was transformed from being relatively closed with substantial government intervention to one of the most open, market-oriented economies in the world.

33. **Singapore's** outstanding trade, FDI and growth performance over decades has been supported by a sound policy framework. This included among other things, steady improvement of macroeconomic, financial, trade, investment, education and infrastructure policy. The Singapore Economic Development Board exemplified the importance of sound governance and effective administration in sustained growth and integration into the world economy.

34. In **Vietnam**, structural reforms, including enterprise law reform — making it easier for firms to enter new businesses — increased the share of foreign and domestic investment in GDP by up to 20 percentage points from two decades earlier and created two million new jobs.

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4 Productivity Commission, 2005, Review of National Competition Policy Reforms, Productivity Commission, Canberra.

5 World Trade Organisation, 2008, Trade Policy Review Report by the Secretariat China, WT/TPR/S/199.

35. A recent study focussing on APEC member economies over 2006-07 showed that behind-the-border barriers were major impediments to both foreign and domestic investment in APEC economies.<sup>6</sup>

36. Broader studies confirm the power of implementing both at-the-border and behind-the-border reforms together. The World Bank surveyed a decade of reforms in the 1990s, concluding that trade reform in some economies yielded few gains in terms of export expansion or increased economic growth.<sup>7</sup> One of the key reasons why was that they had not implemented complementary behind-the-border reforms. An extensive study examining the relationship between pro-competitive reforms and trade in 82 economies over the period 2001-05 found that economies with less competitive markets trade less than their counterparts.<sup>8</sup>

37. The ADB compared the impact of at-the-border trade liberalisation with broader reform that included both at-the-border and behind-the-border barriers for Asian economies.<sup>9</sup> It found that, in contrast with removal of traditional tariff and non-tariff barriers, even modest progress towards removing behind-the-border barriers would have a much greater impact on Asian growth. It concluded behind-the-border barriers to trade are a much greater constraint on growth than protection levels.

## APEC and behind-the-border reform

38. With more liberalisation of at-the-border barriers, international trade being increasingly organised by multinational enterprises and networks of producers, and growing services trade, trade negotiations are moving to address behind-the-border barriers.

39. There are, however, specific challenges related to international efforts to negotiate behind-the-border barriers. Reforms in this area are often more specific to each economy and more demanding approaches are required to removing them and to finding the right balance between international and domestic regulations.

40. APEC's wide membership, its focus on voluntary, non-binding actions and its non-negotiating nature make it a uniquely constructive forum in which to explore behind-the-border barriers and their links with international trade and investment. APEC has taken up this challenge. While at-the-border policy reform in trade and investment remains central, this is now complemented by the LAISR focusing on behind-the-border reform. Moreover, its flagship trade facilitation action plans, and its new investment facilitation plan, cover both at-the-border and behind-the-border reforms.

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6 Centre for International Economics, 2007 'Enhancing Investment Liberalisation and Facilitation in the Asia-Pacific Region (Stage 2): Reducing Behind-the-Border Barriers to Investment', Investment Experts Group, Canberra, Australia.

7 World Bank, 2005, 'Economic Growth in the 1990s: Learning from a Decade of Reform', World Bank, Washington D.C.

8 Miroudot, S, Pinali and Saunter, N (2007) 'The impact of pro-competitive reforms on trade in developing countries', OECD Trade Policy Working Paper No. 54 TD/TC/WP(2006)31/FINAL.

9 Brooks, D H, Roland-Holst, D, and Fan Zhai, 'Asia's Long-term Growth and Integration: Reaching beyond Trade Policy Barriers', 2005, ERD Policy Brief, Series No. 38, Asian Development Bank, Manila.