UNIVERSIDAD DEL PACÍFICO

# Rules of Origin's Trade Rationale and Effects:

**The case of the Chile-Peru RTA and RoO**
negotiating strategy implications

A graduation research by
**Alvaro Henzler & Diego Urbina (2004)**
under the supervision of
**Fernando Gonzalez-Vigil**

## Content

- Introduction
- Methodology
- Effects of the Chile-Peru RTA's RoO in their bilateral trade flows
- Some criteria for a RoO negotiating strategy
- Final remarks

# Introduction: research objectives

- To examine the impact of RoO in the RTA between Chile and Peru on their bilateral trade flows.
- To propose a strategy for the negotiation of RoO, which takes into account not only their intrinsic costs and benefits, but also their effects in priority sectors from an export perspective as well as in sensitive sectors for which some efficient protection has to be established.

## Introduction
# Costs and Benefits of RoO

| | Economic | Political | Business |
|---|---|---|---|
| BENEFITS | + Income growth | + Domestic support to the RTA | + Competitive advantage tool |
| | + Consumer security: better standards | + Protection to sensitive sectors | + Investment and employment in value added activities |
| | + Trade creation: intermediate goods | | |
| | + Investment creation and technological learning | | |
| | + Dumping prevention | | |
| COSTS | + Trade diversion | + Unprotection to input activities | + Compliance and administration costs |
| | + Investment diversion | + Mixed incentives to local R&D | + Transaction and coordination costs (different RoO regimes) |
| | + Imperfect competition or unefficiency in markets | + Protectionist vicious circle | |

# Methodology (I)

- Elaboration of *RoO and Trade Matrixes*, based on:
  - A **classification of sectors** or product groups according to their situation in trade
  - Preference margins or average tariff levels
  - Indexes of RoO **restrictiveness, facilitation and harmonisation**

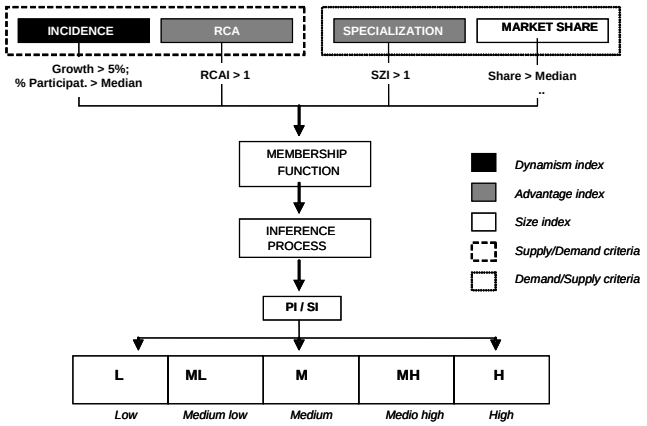
# Methodology (II)

- **Classification of sectors:**
  - ***Priority***: products of the country's **export supply** with revealed comparative advantages significant in level and growth, and also with specialization in the market of destination under study.
  - ***Sensitive:*** locally produced goods having a significant **import demand**, and for which the competing partner's exports have advantages in size, specialization and growth.

# Methodology (III)

Sensitiveness and Priority Indexes between two Countries

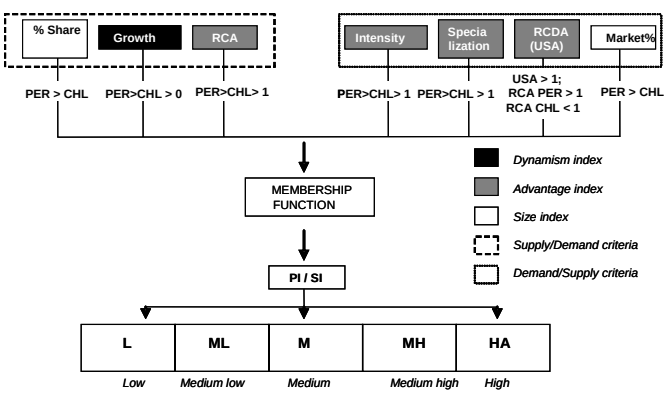
**COUNTRY A – PARTNER B**




# Methodology (IV)

Sensitiveness and Priority Indexes between two Countries considering a competitor

**Country A – Partner B– Competitor C**

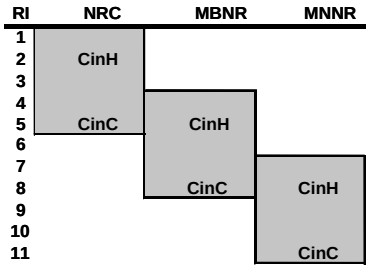


## Methodology (V)

- **Level of RoO Restrictiveness**
  - A Restrictiveness Index (RI) was elaborated, based on an extended version of the one created by Estevadeordal (2000) to assess the RoO in NAFTA. Our RI version possible values go from 1 to 10.5, being 10.5 the most restrictive level for an exporter.

## Methodology (V.1)

- To avoid goods homogenity problems, the RI was estimated independently for natural resource commodities (NRC), manufactures based on natural resources (MBNR) and non based on natural resources (MNNR).



# Methodology (VI)

- **Level of RoO Harmonisation**
  - As a new methodological tool for the analysis of RoO, a Harmonisation Index (HI) was calculated, expressing the distance between two vectors representing the demanding levels of two RoO regimes (A and B).

$$d\,\overline{AB} = \sqrt{(a_1 - b_1)^2 + (a_2 - b_2)^2 + ... + (a_n - b_n)^2} = \sqrt{\sum_{i=1}^{n} (a_i - b_i)^2} = |A - B|$$

$$d\,\overline{AB} = \sqrt{\alpha_1 (CCT_A - CCT_B)^2 + \alpha_2 (Ex_A - Ex_B)^2 + \alpha_3 (RCT_A - RCT_B)^2 + \alpha_4 (\%RC_A - \%RC_B)^2 + \alpha_5 (TECH_A - TECH_B)^2}$$

# Effects in Trade (I)

- **RoO and Trade Indexes**

| | PI | | SI | | Preference Margin (PM) | | RI |
|---|---|---|---|---|---|---|---|
| | 95-98 | 99-02 | 95-99 | 99-02 | 1998 | 99-02 | 98-02 |
| ***Tariff lines with high RI*** | | | | | | | |
| 05 - FRUITS and VEGETABLES | H | H | M | M | 28.32 | 52.58 | 4.06 |
| 26 - TEXTIL FIBRES | H | H | MH | H | 98.05 | 98.48 | 6.29 |
| 54 - MEDICINES and PHARMACEUTICALS | M | L | H | H | 64.16 | 73.42 | 4.31 |
| 65 - YARNS and FABRICS | MH | M | MH | MH | 22.99 | 56.62 | 5.29 |
| 77 - ELECTRICAL MACHINES & EQUIPMENT | L | L | MH | MH | 10.26 | 37.74 | 4.01 |
| 84 - CLOATHING & GARMENTS | H | H | M | MH | 13.33 | 36.43 | 5.85 |
| ***Peru's priority tariff lines with high PM*** | | | | | | | |
| 28 - MINING PRODUCTS | H | H | L | L | 100.00 | 100.00 | 4.00 |
| 29 - ANIMAL & VEGETABLE RAW PRODUCTS | H | H | M | M | 84.71 | 90.83 | 4.00 |
| ***Chile's priority tariff lines with high PM*** | | | | | | | |
| 23 - NATURAL RUBBER | L | L | H | H | 100.00 | 100.00 | 4.00 |
| 56 - FERTILIZERS | L | L | H | H | 83.33 | 90.00 | 4.00 |

# Effects in Trade (I.1)

- **Analysis**
  - RoO with high RI reinforce a relatively low preference margin (due to a slow pace of tariff reduction).
  - High RI tend to be associated to low preference margins, as well as to a high PI or to a high SI before the RTA entry into force.
  - When there is no competition rivalry, immediate or rapid tariff reduction and RoO with low RI are negotiated.
  - In tariff lines with high RI, the PI decreases or remains the same, and the SI increases or remains the same, after the RTA entry into force.

# Effects in Trade (II)

- **RoO-RI and Trade Indicators**

| ITSC | Preference Margin 1998 | Preference Margin 99-02 | RI | RCA | Market Share | Specialization | Intensity |
|---|---|---|---|---|---|---|---|
| 26 - Textil Fibres | 98.1 | 98.5 | 6.29 | ↑ | ↓ | ↓ | ↓ |
| 28 - Mining products | 100.0 | 100.0 | 4.00 | ↑ | ↑ | ↑ | ↑ |
| 29 - Animal & Vegetable Raw Products | 84.7 | 90.8 | 4.00 | ↑ | ↑ | ↑ | ↑ |

# Effects in trade (II.1)

- **Analysis**
  - Very exigent RoO (high RI) may provoke some of the following outcomes:
    - A fall in RCA, or
    - A gain in RCA, but accompanied by falls in market share, specialization and intensity in trade with the RTA partner, or
    - A rise in some of those other three trade indicators, though as the result of a high margin of preference, and often the rise is relatively minor compared to the cases when the RI is low.

# Criteria for a RoO negotiating strategy (I)

- **Phase 1- RoO according to PI and SI in trade**

| "Optimal RI" | Trade condition | Rationale |
|---|---|---|
| **RI Low** | if SI low, either with PI high or low | *Country looks for real market access, actual or potential* |
| **RI Medium Low** | if SI and PI high both | *Country looks for real market access, yet also for some trade protection* |
| **RI Medium High** | if SI high and PI Medium | *Country looks for trade protection, yet also for some real market access* |
| **RI High** | if SI high and PI low | *Country looks for trade protection* |

# Criteria for a RoO negotiating strategy (II)

- **Phase 2 – RoO maximizing harmonisation**
- **Phase 3 – RoO to advantage a competing partner**

| If… | | | | then… |
|---|---|---|---|---|
| RI* > RI** | ^ | PI = H or MH | ⟹ | Seek for lower RI |
| RI* > RI** | ^ | SI = H or MH | ⟹ | Seek for higher or same RI |
| RI* < RI** | ^ | PI = H or MH | ⟹ | Seek for lower or same RI |
| RI* < RI** | ^ | SI = H or MH | ⟹ | Seek for higher RI |

RI* Own country index level
RI** Competing country index level

# Criteria for a RoO negotiating strategy (III)

- **Phase 4 – RoO in view of a next partner's interests in tariff elimination**

| | SI | PI |
|---|---|---|
| - | M | L |
| | M | ML |
| | M | M |
| | MH | L |
| COST | MH | ML |
| | MH | M |
| | H | L |
| | H | ML |
| + | H | M |

- *To identify the RoO associated to products in each of the tariff elimination schedules proposed by the next partner*
- *To adjust the negotiations of tariff elimination schedules and RoO according to the SI and PI by tariff line.*

# Final remarks (I)

- **Contributions of this research**
  - A new methodological tool for calculating the degree of harmonisation of RoO.
  - A methodology linking RoO's RI by tariff lines to their trade condition (PI or SI) and other trade indicators.
  - A strategy for the negotiation of RoO, based on:
    - Levels of restrictiveness reflecting national productive conditions
    - Lessening the implicit costs from low or nil harmonisation and the explicit costs from too exigent RoO
    - Gaining advantages regarding a competitor in a given export market
    - Identifying possible RI levels to be sought for by a next negotiating partner, in view of its SI and PI at the relevant trade flow levels.

# Final remarks (II)

- A general policy recommendation
  - RoO negotiations should look for ensuring **real market access in priority sectors** having comparative advantage, and should help to **adjustment in sensitive sectors** still without comparative advantage but showing positive trends in other trade indicators. The needed adjustment, to be efficient, should rely mostly on competitiveness-oriented domestic policies.