PREFERENTIAL TRADE AGREEMENTS: IS THERE A NEXT STEP?

Preferential trade agreements can divert trade to less efficient producers, warns **David Robertson**

Preferential trade agreements (PTAs) between two or more countries have become widely regarded as instruments of globalisation that bring economic benefits to rich and poor countries alike. Misleadingly, these agreements are often referred to as 'free trade areas,' although their commodity coverage is limited and preferences are partial. When ministers sign such agreements, they are acclaimed as negotiating triumphs. Media commentators and politicians praise the achievement and list advantages from increased exports and improved diplomatic relations. But the costs of trade diversion to more expensive imports from less-efficient partner suppliers, and the global costs of diminishing economic efficiency, are ignored.

When the General Agreement on Tariffs and Trade (GATT) was established in 1948, preferences were regarded as divisive and trade-restricting. Yet, at that time, some GATT contracting parties were already committed to customs unions and free trade areas. So article XXIV was included in the General Agreement to set conditions for these discriminatory agreements, including complete removal of all trade barriers between members on substantially all trade within ten years. Article XXIV remains in the GATT (1994), which was incorporated into the World Trade Organization (WTO) established in April 1994. Few PTAs have even attempted to meet these GATT conditions.

The Uruguay Round's shortcomings

Interest in PTAs revived in the 1990s when the Uruguay Round of multilateral trade negotiations ran into difficulties. In December 1990, complex but crucial negotiations on agricultural trade broke down. The disappointed US administration decided to open bilateral trade negotiations with Canada and Mexico to establish the North American Free Trade Agreement (NAFTA), based on three separate bilateral trade agreements (to comply with the US *Reciprocal Trade Agreements Act*). Favourable publicity given to the EU's *Single European Act* (1986) encouraged this North American initiative.

Similar concerns about the viability of the multilateral trading system also persuaded the six ASEAN countries (Indonesia, Thailand, Philippines, Malaysia, Singapore, and Brunei) to negotiate bilateral trade agreements in 1992. These PTAs (containing many exceptions) became known collectively as AFTA. More recently, each ASEAN country has established bilateral PTAs with the Mekong countries (Vietnam, Cambodia, Laos, and Myanmar). Bilateral PTAs have also

David Robertson is a former Commissioner of the Productivity Commission, and was previously a Professor of economics at Melbourne University.

become a feature of trade in southern Africa and Latin America.

After the *Final Act of the 1986–1994 Uruguay Round* was adopted, discriminatory trade arrangements increased, indicating widespread dissatisfaction with the negotiated outcomes. Non-OECD countries objected to the WTO agreement as a 'single undertaking' (that is, adopted in its entirety by all participants, when previous GATT negotiations had established 'special and differential' treatment for developing countries). It imposed unexpected costs on developing countries.[1]

On the other hand, OECD governments were unhappy that agreements were not achieved to release trade from the impediments imposed by domestic policies on competition, labour laws, investment, patents and copyright, government procurement, and so on.

The PTA precedents set while the Uruguay Round was in progress provided an alternative trade instrument, which created vested interests against comprehensive multilateral liberalisation. Latest estimates suggest that over four hundred PTAs are already in place or have been declared to the WTO ahead of their commencement.

Multilateral rules and periodic negotiations were strengths of the GATT and carried over into the WTO. But WTO ministerial meetings in Singapore (1996) and Seattle (1999) showed wide divisions between OECD and developing countries. Hopes of reviving multilateral negotiations at the WTO Fourth Ministerial Conference in Doha (2001) were frustrated when traditional GATT issues, such as agricultural protection and balanced tariff reductions, subverted the development agenda. The PTA alternative received another push.

When the US president's negotiating mandate lapsed on 1 July 2007, little enthusiasm remained among negotiators in Geneva. With the new Democratic US Congress exhibiting protectionist sentiments against new bilateral agreements (PTAs agreed with Colombia and South Korea are under review), the prospects for a new US president to revitalise the Doha Round in 2009 are not good. US freedom to negotiate PTAs is restricted to bilateral agreements.[2]

For many OECD governments, PTAs have become the means to achieve reductions in 'beyond-the-border' impediments to foreign investment and trade. At the same time, PTAs allow developing countries to avoid pressures to liberalise trade or domestic policies, which are implicit in WTO/GATT agreements. Market opportunities can be pursued with their neighbours, and OECD interests can be ignored.

Misleading bilateralism

Dissatisfaction with the complex procedures of the Uruguay Round and the burdens imposed on developing countries by the 'single undertaking' condition have reduced many developing countries' governments willingness to negotiate on sensitive topics. PTAs have become their instrument of choice. This contradicts the principles of multilateralism and non-discrimination (the foundations of the WTO/GATT system) by allowing selective treatment of products according to their source.[3]

By promoting scrutiny of bilateral trade balances, PTAs encourage mercantilism (which views exports as good but imports as bad), discriminate against efficient third-country suppliers, and undermine the multilateral trading system.

In Australia, assessment of the Australia–US free trade agreement is often based on the bilateral trade balance. But Australia's bilateral trade deficit with the US is irrelevant. Both countries happen to have large trade and current account deficits with the rest of the world. At present, these are financed by large voluntary capital inflows. In Australia's case, these are large enough to appreciate the Australian dollar against many currencies. International capital markets and foreign exchange markets maintain equilibrium in national accounts. Bilateral trade balances are unimportant, and seeking to rebalance a bilateral deficit is futile in a multilateral trade and finance regime.

Similar unsatisfactory features are likely to appear if Australia agrees to PTAs with other large economies, such as China, Japan, or India. PTAs increase the influence of major economies and enhance the influence of their domestic pressure groups, such as farmers and landowners. That is why small countries are better served by multilateral trade rules.

Although PTAs create new opportunities for trade with partner countries, they also divert trade from other trade partners, which may be

more efficient, lower-cost sources. The cost of trade diversion arising from PTAs is seldom acknowledged.

For example, a uniform multilateral import tariff of 10% encourages imports from the lowest-cost source. But if a PTA reduces the tariff to zero for the partner country (while maintaining its most-favoured-nation tariff at 10%), imports may come from the partner at prices up to 10% higher than the lowest-cost source. This reduces benefits to domestic consumers by continuing to protect high-cost domestic producers while raising profit margins in partner countries.

The loser is the efficient third-country producer who still faces the tariff. The case for multilateral free trade is that it shifts domestic production away from import-competing domestic producers, bringing gains from more efficient domestic production (specialisation) and lower prices to consumers. Trade diversion to higher-cost partner suppliers is the cost of preferential trade. Australian farmers complain about this kind of trade diversion in the proposed US–South Korea PTA.

One of the major complications with PTAs concerns 'rules of origin.' 'Trade deflection' occurs when a third country's product is passed through a low-tariff partner country into a higher-tariff partner country. PTAs apply 'rules of origin' to define which products passing between member countries should receive trade preference. Usually, the definition refers to 'value added' in the PTA (say, 50% of imported value), a change in tariff classification, or identifying a particular process (such as fabricating a special steel). In many PTAs, these 'rules of origin' are very detailed, covering hundreds of pages and taking many months or years to negotiate. Differences among 'rules of origin' in different PTAs can create disguised protection, especially if a country participates in several PTAs—as all AFTA countries do.

Above all, 'rules of origin' increase the cost of doing business—so much so that only 10% of intra-AFTA trade is estimated to take advantage of preferential tariffs.

Political support

While economists are suspicious of preferential trade in all its forms, politicians and trade officials seek such agreements. As mentioned above, the increase in intra-regional trade is often low. In favourable circumstances, a PTA can be negotiated in a year or so, whereas a WTO/GATT agreement is reached only once every ten to fifteen years. The former is obviously more popular among ambitious negotiators.

Speaking at a recent WTO conference in Geneva, its director-general, Pascal Lamy, remarked, 'The reality is that bilateral free trade agreements have a political comparative advantage. If you are a politician and you want to increase your brownie points domestically, bilateral agreements are good.' He should know. Previously, Lamy was the EU Commissioner for Trade, and had a reputation for obduracy.

Lamy announced a new WTO review mechanism for PTAs in December 2006. This was intended to give teeth to the Committee on Regional Trade Agreements, established in 1996. This latter committee has never reported to the WTO General Council. The new review process has not found any infringements either.

> Trade diversion to higher-cost partner suppliers is the cost of preferential trade.

East Asian countries have become willing exponents of PTAs since multilateralism was threatened in the Uruguay Round. These countries had benefited materially from GATT liberalisation leading up to 1990. AFTA now has ten members, after incorporating the four Mekong countries. It still comprises bilateral PTAs linking all ten members (that is, forty-five agreements). The commodity coverage is restricted by diversities in their economic development and by political differences.[4]

The rapid development of Chinese industries since 1990 has increased competitive pressures on AFTA members' exports. In 2001, ASEAN countries completed another round of (ten) bilateral PTAs with China. Intra-ASEAN trade has been stable at around 23% of total trade for some years, indicating that the bloc's mutual trade has benefited little from PTAs.

This is not surprising, because 'rules of origin' and long product exception lists create bureaucratic mazes (and expenses) that discourage

businesses from seeking preferential duties in ten separate constituencies. Only 10% of intra-AFTA merchandise trades receive 'area treatment' (that is, tariff preferences).

Notwithstanding the ineffectiveness of PTAs, new trade affiliations are under consideration, such as ASEAN +3 (adding China, Japan, and South Korea) and ASEAN +6 (with the further additions of Australia, New Zealand, and India). These groups would have to overcome serious political and economic differences. As membership increases, cross-frontier commerce using bilateral PTAs becomes more complex and more expensive. Only if the present bilateral agreements are converted into a GATT-consistent free trade area will the significant benefits of free trade be available. The political impediments to this are formidable.[5]

Naturally, the Asian PTAs attract the interest of Australian ministers and diplomats, but it is not easy to get the attention of Asian governments. Separate PTAs signed with Singapore and Thailand do not compensate for the cold shoulder from China, Japan, and the collective AFTA. Moreover, anxiety generated by the draft US–South Korea FTA is unlikely to help Australian negotiations with South Korea.

The new Labor government seems to have triggered a conciliatory response from China. Simon Crean, the minister for trade, has been to Beijing for preliminary talks. However, East Asian governments always respond politely to such enquiries. These are early days, and uncertainties about the global economy, relations with Japan, and doubts about US trade policy under a new president in 2009 make any current assessments of prospects for PTAs problematic.

The multilateral alternative

The Doha Round has been in progress for seven years. In spite of periodic optimism, even broad topics like tariff-cutting formulas, agricultural definitions, and development exceptions are undecided. With the US authorities disabled by loss of negotiating powers and faced by a hostile anti-trade Congress, the EU arguing to protect its common agricultural policy (CAP), and developing countries reluctant to liberalise and unable to agree on definitions of sensitive products, the prospects for early progress in Geneva were never good. Certainly, the collapse of the talks late in July has killed off any hope of completing them any time soon. Significant changes in attitudes from all the participants will be necessary, including an awakening to the dangers of bilateralism.

Australia has reduced most of its import tariffs to low levels, which has brought improved domestic economic efficiency and economic growth. The multilateral approach still offers most benefit to the Australian economy because its exports are widely distributed.

An enterprising regional alternative would be to pursue a common agreement incorporating all the East Asian PTAs into a single free trade area agreement, consistent with GATT article XXIV. This approach is regarded as inconsistent with 'the Asian way,' because regional history and mutual suspicions demand that bilateral national concessions should be carefully assessed. Yet the APEC route appears to have reached its limits after ill-considered extensions to include Russia and a variety of Latin American states. On the other hand, with the EU, the US, India, and others courting ASEAN and China for trade agreements, now might be an appropriate time to seek common ground. It is claimed that economics rules Asian diplomacy, and that cross-border economic links underpin political stability. These forces should work towards a regional trade agreement consistent with GATT article XXIV, which would bring new economic opportunities.

Endnotes

1 J. Michael Finger, 'Implementing the Uruguay Round Agreements: Problems for Developing Countries,' *The World Economy* 24:9 (2000).

2 C. Fred Bergsten, *The United States and the World Economy* (Washington: Institute for International Economics, 2005).

3 For a full discussion, see David Robertson, *International Economics and Confusing Politics* (Cheltenham, UK: Edward Elgar, 2006), chapters 4–6.

4 Richard E. Baldwin, 'Managing the "Noodle Bowl": The Fragility of East Asian Regionalism,' CEPR (Centre for Economic Policy Research) Discussion Paper 5561 (Geneva: CEPR, 2006).

5 P. Drysdale, 'Regional Cooperation in East Asia and FTA Strategies,' *Pacific Economic Papers* 344 (Canberra: ANU, 2005).