

## **Submission to the Productivity Commission's Review of Bilateral and Regional Trade Agreements**

P. J. Lloyd

This submission contains some reflections on the Productivity Commission current Review of bilateral and regional trade agreements. It focuses on the general direction of this review and what we might expect to learn from it. It is organised under a series of headings of major aspects of the Review.

### **Terms of reference**

The Terms of Reference of the Review are very general in that they ask the commission to examine the impact of bilateral and regional agreements collectively, rather than to examine specific actual or prospective agreements or features thereof. There certainly are a number of general issues arising from the six agreements already signed and the agreements under negotiation. However, one must also be aware that the agreements differ greatly in coverage of goods and services, depth of trade liberalisation cuts, modalities and other respects. Any conclusions must bear these differences in mind.

### **Trade liberalisation or economic integration**

One of the important differences is in the objectives of the agreements. These differ considerably among the six actual agreements. In particular, one should distinguish between agreements that pursue the objective of “trade liberalisation”, as mentioned in the Terms of Reference, and those that pursue the objective of “economic integration”. The Closer Economic Relations (CER) agreement between Australia and New Zealand is distinct from the other five actual agreements in that it has evolved into an agreement that can be regarded as pursuing the objective of economic integration. In January 2004 the Australian and New Zealand Prime Ministers announced an intention of creating a “single economic market” (Prime Ministers Howard and Clark, 2004). While the term “single economic market” was not defined, it is modelled after the Single Market created by the European Union in the Single European Act of 1987. It encompasses liberalisation of trade in the labour and capital markets as well as in the markets for goods and services, and also many beyond-the-

border regulations of markets and standards. The scope of policies covered by this objective is much wider than that of other agreements signed by Australia. The submitter has expressed his views of the meaning of a single market in Lloyd (2005). Consequently, the assessment of CER must consider economic effects not present in other agreements, notably those on labour and capital markets.

### **The relationship between bilateral/regional trade liberalisation and multilateral liberalisation**

One of the central aspects of the movement towards bilateral/regional agreements is the relationship with the movement towards multilateral liberalisation.

The Terms of Reference ask “What role should trade agreements play in supporting the international trading system and the WTO?” The answer to this question must emphatically be that bilateral/regional agreements cannot support the multilateral system in terms of trade among nations on equal MFN terms. The trade liberalisation measures adopted in these agreements with respect to goods and services markets are inescapably discriminatory, and therefore a breach of the MFN Principle as enshrined in Article I of GATT 1994 and in GATS. There is, to my knowledge, no instance in the Australian history of trade liberalisation of any bilateral/regional trade liberalisation measure adopted since 1983 being extended on an MFN basis to third parties. All of the measures adopted have, therefore, extended trade discrimination.

There are other issues concerning the effects of the adoption of these discriminatory measures on the incentives for Australia, its bilateral/regional partners, and all countries to pursue multilateral trade liberalisation. One important issue is the so-called “building block or stumbling block” issue. A number of studies, including some conducted by the WTO itself, have concluded that regional trade agreements have not discouraged multilateral trade liberalisation. I concur. Yet, the incentive effects which bilateral/regional agreements have must generally be towards weakening the incentives to multilateral liberalisation as bilaterals and regionals provide an alternative to gaining improved market access in world markets. This is especially true when the agreement is between a small trading country such as Australia and a partner or partners with large markets. Indeed, when bilateral/regionals do succeed in opening up significantly important overseas markets,

they create an incentive to preserve the preferences gained; witness the opposition of ACP countries in the current Doha Development Round negotiations to “preference erosion”.

### **Assessing the “economic impact” of agreements**

The Productivity Commission Issues Paper refers specifically to the “economic impact” of trade liberalisation measures. It states that “Economic theory suggests that whether these effects will be positive or negative depends in part on whether the particular trade agreement in question is ‘trade diverting’ or ‘trade creating’.” Even with the qualifier “in part”, this statement is not true. The theory of customs unions, as the theory of trade discrimination is usually called, shows clearly that trade-diversion does not necessarily lower the welfare of the country whose trade is diverted. Vinerian trade diversion is a kind of terms of trade effect. By itself, this effect is welfare-reducing. However, the discriminatory reduction in the tariff or other measure that causes the trade diversion also changes relative prices to producers and consumers and these accompanying production and consumption effects are positive and may offset the negative terms of trade effect. This is explained in any good textbook. The submitter’s views on this basic aspect of discriminatory trade theory are set out in Lloyd and Maclaren (2004).

There are two further reasons why trade analysts in Australia need not waste time on attempts to assess trade diversion costs. The first reason is that, as the number of trading preferential partners with whom we trade in the market for any importable expands as the number of agreements expands, the possibilities of (harmful or beneficial) trade diversion diminish. With multiple partners, trade diversion must have diminished considerably since the signing of the first agreement with New Zealand in 1983. If Australia does sign an agreement with the Republic of China in the near future that is reasonably comprehensive in terms of commodity coverage and depth of cut, we can forget about trade diversion as China is the least-cost supplier of so many of the imported manufactures subject to border barriers.

The second reason is Australia’s MFN barriers to imports of goods has been greatly reduced in the last twenty years. For both goods and services markets, Australia is now one of the most open economies in the world. Apart from the two partners New

Zealand and Singapore, Australia's barriers to imports of goods and services are generally lower than the barriers to goods and services exported from Australia into the markets of the partner countries. To put it another way, our concern with the effects of bilaterals and regions on market access should be primarily with the effects on our export market rather than our import markets.

In my view, there is little value from any attempt to measure systematically these impacts for all actual agreements. Post-hoc evaluations by means of computable general equilibrium modeling have a number of inherent limitations. They are mostly limited to goods trade, conducted at level of aggregation that mixes preferential and non-preferential trade and most importantly they do not model the all-important rules of origin for each agreement. The same conclusion applies a fortiori to gravity models which are a reduced form of the trading model and do not even incorporate trade preferences on individual goods or categories of goods.

Much more value is to be had from a careful microeconomic examination of particular measures adopted in particular agreements. If we wish to learn from our experience with bilaterals and regions, I suggest the Productivity Commission carry out or commission a number of carefully selected case studies. For example, with respect to CER (our most comprehensive and open agreement by far), I suggest an examination of the benefits of individual measures. Two examples are the exemption of the trans-Tasman partner from anti-dumping actions and the agreement to abolish (beyond-the-border) subsidy measure that affect trans-Tasman trade, which was contained in the Agreed Minute on Industry Assistance 1988. A third example is the effects of change in rules of origin for CER trade from the original percentage test, that applied from 1983 to 2004, to a change to a tariff classification test that was announced by the Trade and Economic Ministers of the two CER countries in December 2004, with effect from 1 January 2007.

The last two individual measures provide an opportunity to examine policy changes that is rare in the global history of bilateral and regional agreements. The only other bilateral/regional agreement to encompass a restriction on the practice of subsidy measures that I am aware of is the prohibition on "state aids" in the original European Treaty of Rome but this has been ineffective (as noted in many of the annual reports

of the Directorate-General IV). Similarly, the change in the method of rules of origin assessment provides a rare opportunity to examine post hoc the impact of the change on actual trade between the countries, holding constant all other border restrictions. (For a discussion of rules of origin in the CER area, see Lloyd and MacLaren, 2009). Similarly, an examination of features of the Australia-US FTA such as the provisions relating to foreign direct investment and intellectual property could suggest important lessons for the negotiation of future agreements.

There is another dimension of the economic impact of bilateral regional trading agreements that has barely been mentioned in the Issues Paper, namely, the effect of these agreements on the rate of economic growth. In an important recent paper Estevardeordal and Taylor (2008) discuss the evidence that trade liberalisation raises the long-term rate of growth of real GDP per capita. This prospect applies to regional trade liberalisation as well as multilateral liberalisation (see Lloyd (forthcoming) on this aspect.) If this view is correct, the effects on longterm productivity and rate of growth are likely to be much more important than the comparative static effects that have been analysed to date.

### **Best practice principles**

The Issues Paper refers to the possibility of adopting best practice principles, along the lines of those developed by APEC and the Asian Development Bank. In my view, this would be a futile exercise. The primary reason is that Australia is not in a position to impose its view of best practise terms and measures during negotiation of bilateral or regional agreements. Any terms must be mutually acceptable. Australia cannot dictate terms to potential partners such as China, Japan, Korea or the Trans-Pacific Partnership, all of which are much bigger traders than Australia and all of which have rather different views of bilateral/regional trade and different precedents.

If we had wanted a model, we could not have done better than the original CER agreement as extended in the 1990s. This is the cleanest and least bureaucratic agreement anywhere in the world and is more trade-liberalising and integrating than any other agreement in the world except the European Union. However, in subsequent negotiations that Australian Government has shown no inclination to push CER better practice principles and modalities.

### **Future agreements**

Of the agreements under negotiation, one of the most important is the Trans-Pacific Partnership Agreement. Some economists see these negotiations as a possible basis of an agreement extending to the whole of the Asia-Pacific region and incorporating best practices.

This is possible but doubtful. The present agreement between the four original parties –Brunei Darussalam, Chile, New Zealand and Chile – is very open but restricted to goods trade. The US is a party to the current negotiations and will no doubt seek to impose its own template based on NAFTA, as it has in all US post-NAFTA negotiations.

These negotiations illustrate another feature of the emerging world trading scene. Australia already has bilateral or regional agreement with all four original members and with all of the new parties to the negotiations – the US, Peru and Vietnam – with the solitary exception of Peru. Why do we need another agreement with the same parties? The answer must be partly the inadequacies of the present agreements and partly the prospects of expanding the agreement subsequently to other parties.

With regard to the former of these reasons, one may note that in the case of Singapore and New Zealand, we already have two agreements with Singapore and two with New Zealand, one bilateral (the Singapore-Australia FTA and CER respectively) and one regional (the ASEAN-Australia-New Zealand Agreement). If the TPP Agreement is concluded with the present parties to the negotiations, we shall have three agreements with the same two countries. This adds greatly to the complexities of market access and other aspects and is surely not the way to reduce complexity and compliance costs.

### **APEC**

The Issues Paper lists APEC as one of the current bilateral/regional agreements to which Australia is a party. APEC is quite different in nature from all other regionals and bilaterals already concluded or under negotiation. It is a forum whose agreements are non-binding and non-reciprocal, unlike the other agreements, and it has not

negotiated any opening of trade in goods and services. It is not listed in the WTO RTA Database for the very good reason that to it is not notifiable under WTO rules, not being either a free trade area or a customs union. If APEC is included in any Productivity Commission analysis, it should be treated as distinct from all binding reciprocal bilaterals and regionals.

### **An Asia-Pacific Community or an East Asian Community**

The possibility of an agreement in the Asian or Pacific or Asian-Pacific region is the most important issue relating to the evolution of the future architecture of RTAs affecting Australia, in my view. The difficulty here is that many different country configurations have been canvassed in the Asia region, Australia and in APEC. Some include Australia and some do not. The Productivity Commission should compare and evaluate these possibilities.

P. J. Lloyd

Emeritus Professor,

The University of Melbourne

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