

**Productivity Commission Inquiry  
on  
Bilateral and Regional Trade Agreements**

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Summary

The GATT played a crucial role in restoring the world economy to health after World War II and the 1930s Depression. The restoration of democracy to East European countries and their accession, with many developing countries, to international institutions brought unexpected changes and a new agenda. Regional trade agreements, which had been regarded, justifiably, as ‘second-best’ policy instruments, replaced multilateral negotiations. Politics had overwhelmed economics in trade and in development policies.

When Uruguay Round negotiations were suspended in 1990, preferential trade agreements became the instrument of choice for many governments. They were justified by reference to GATT article XXIV, although none meet the conditions prescribed there. Now more than 400 PTAs have been notified to the WTO, and a web of different requirements is created for traders in rich and poor economies. Rules of origin and complex tariff schedules have to be negotiated, while trade creation and trade diversion cause confusion over benefits.

The loss of MFN treatment for small economies is damaging. Major trading economies become ‘hubs’ to a series of PTA ‘spokes, which allows them to exploit market power. The complexities introduced into each country’s tariff schedule condemn many traders to pay MFN tariffs even if preferences are available, because customs officials are unfamiliar or confused by multiple preference agreements. Moreover, ‘hub’ economies can exploit petitioning ‘spokes’ into accepting unjust conditions that are outside WTO agreements, for example labour laws and environment standards.

The outcome of bilateralism is exploitation, economic inefficiencies and resentment. When globalisation is available, regionalism becomes speculative.

Canberra, 7 April 2010

## Bilateral and Regional Trade Agreements

*The doctrine of free trade, however widely rejected in the world of policy, holds its own in the sphere of the intellect.*

-- Frank Taussig

Before the GATT Uruguay Round Final Act was authorised in April 1994, many of the principal negotiating governments (GATT Contracting Parties) had reached, or were negotiating, formal agreements to establish bilateral (sometimes regional) trade agreements. Although nominally authorised by GATT article XXIV<sup>1</sup>, few of these had much regard for the conditions of that article. This trend has continued unabated, notwithstanding the WTO Council decision to commence the Doha Development Round negotiations in November 2001. Commitments to multilateral trade liberalisation have weakened as bilateral agreements have spread.

Approximately 400 preferential trade agreements (PTAs) have been notified to the WTO Council so far -- a four-fold increase since 1994, when the Uruguay Round negotiations were completed. Few of these PTAs<sup>2</sup> are consistent with the requirements of GATT article XXIV, to wit covering substantially all trade between two or more countries and eliminating tariffs on mutual trade within a reasonable period, now established as ten years. In practice, PTAs tend to avoid sensitive protected sectors (such as agriculture and fishing), which reduce product coverage. Transition periods for these selective agreements now vary according to their membership and scope.

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<sup>1</sup> The purpose of a customs union or of a free-trade area should be to facilitate trade between the constituent territories and not, on balance, to raise barriers to the trade of other contracting parties.

<sup>2</sup> Preferential Trade Agreement (PTA) is used as a generic term referring to customs unions, free trade areas or other preferential trade arrangements justified using GATT article XXIV (although not necessarily consistent with the spirit of that article). Customs unions require serious negotiations that spill over into domestic policies. For many years the provenance of GATT article XXIV was thought to have been West European countries considering economic integration to enhance their economic security after WWII. Recent research, however, has revealed that it was the US State Department that slipped article XXIV into the 1948 draft of the General Agreement. (Chase (2006)).

While PTAs eliminate tariffs on bilateral trade, they can also modify domestic rules and regulation to facilitate access to partner economies. Even so, these agreements often result in only small increases in bilateral trade (trade creation), usually at the expense of other countries' exports (trade diversion). Frequently, these agreements now cover trade in services and some relax provisions affecting investment, competition policy, government procurement and intellectual property rights. These 'beyond-the-border' measures cover licensed businesses, regulated activities, various administrative restrictions, operating permits, etc, which open new business opportunities for residents of partner countries.

There has been a pronounced increase in north-south PTAs, with commitments to reciprocity on both sides<sup>3</sup>. The most significant are economic partnerships agreed between the European Community and former colonies in Africa, the Caribbean and the Pacific (ACP countries). In addition, the European Community has negotiated agreements with Mercosur, other individual Latin American countries, and now it is making approaches to Asian economies (eg Korea and Vietnam). (Notably, the European Commission is always careful to protect the CAP.)

Major economies, such as US and EU (and nominally, Japan and China) have become 'hubs' for a series of PTA 'spokes' with smaller economies<sup>4</sup>. Most PTAs are bilateral agreements involving these major traders as 'hubs'. When this involves north-south agreements they tend to weaken cooperation for regional groupings among developing countries.

All PTA's are notified to the WTO Secretariat, but evaluation of these agreements has always been rudimentary and non-controversial. A new transparency mechanism was introduced by the CRTA in 2006, which produces factual presentations of notified PTAs (twelve were recorded in the first year to May 2008). This permissive attitude has been evident since the earliest regional trade arrangements were formed in the 1950s.

Many developing countries are now forming their own trade groups, usually with weak conditions (eg SACU<sup>5</sup>, CAFTA<sup>6</sup>, ECOWAS<sup>7</sup>, COMESA<sup>8</sup>, etc). In

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<sup>3</sup> "(EU) PTAs with ACP states have been driven by development objectives ...with an increased focus on reciprocity." Heydon and Woolcock (2009) p.9.

<sup>4</sup> See R.J.Wonnacott, "Trade and investment in a 'hub-and-spoke' system," *The World Economy*, 1996.

<sup>5</sup> SACU; South African Customs Union.

1971, a special GATT waiver granted developing countries ‘special and differential’ access for their exports to developed economies. These preferences were made permanent in 1981 by a decision of GATT Contracting Parties; “Differential and more favourable treatment, reciprocity and fuller participation of Developing Countries” (Jackson (1990)).

The Doha Development Round of trade negotiations, agreed by WTO ministers in November 2001, has been suspended for long periods and looks to be beyond help while the global financial crisis lasts. Yet the GATT was one of the successful international institutions established after WWII. Why has it suffered an embarrassing relegation since it was re-badged as the WTO in 1994? Why have regional trade agreements – long regarded as ‘second best’ instruments<sup>9</sup> – displaced traditional ‘first best’ multilateral liberalisation according to GATT principles? Why did governments turn away from multilateralism? Why did developing countries aspire to full participation in the Uruguay Round and set aside their protection granted by “The Enabling Clause” (1981)?

### **GATT and recovery**

GATT became the agency to manage international trade by default after the US failed to ratify the Havana Charter (1949). It was the commitment to GATT that underpinned global trade for the next 50 years, based on the principles of most-favoured-nation treatment, tariff binding and reciprocity in periodic negotiations to dismantle tariffs.

GATT principles supported economic recovery in post-war Europe. Gradually during the 1950s, a consensus developed in West European countries to reduce the protectionist policies inherited from beggar-my-neighbour strategies in the 1930s and exacerbated by wartime disruption.

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<sup>6</sup> CAFTA; Central American Free Trade Agreement.

<sup>7</sup> ECOWAS; Economic Community of West African States.

<sup>8</sup> COMESA; Common Market for Eastern and Southern Africa.

<sup>9</sup> ‘Second best’ theory assesses what happens when optimum conditions are not fully met. The failure of one condition does not mean the other optimum conditions will necessarily be included in the next best solution (ie second best). In fact, none of the other optimum conditions may be relevant to the ‘second best’ solution. See R.G. Lipsey and K. Lancaster, ‘The general theory of ‘second best’, *Review of Economic Studies*, vol.24 1956-7; and R.G. Lipsey, ‘The Theory of Customs Unions: A General Survey,’ *Economic Journal*, vol. 70 Sept. 1960. See also W. M. Corden, (1965), ch. V.

Enterprising new businesses realised that latent protection was holding back the development of domestic markets and exports. The new industries sought trade liberalisation, which brought them into conflict with domestic protectionists. The GATT became the ally of enterprising industries and governments that recognised opportunities to encourage modern industries. Efficient domestic producers (potential exporters) took common cause to reduce barriers to trade, not out of goodwill (or other noble gestures) but because they needed freedom to adjust and to grow. In the first post-war decade, these economic strategies gradually took hold in Western Europe, supported by Marshall Aid and other US assistance.

The case for free trade was accepted economic lore, but for 30 years government controls were the norm. GATT rules provided the levers to effect trade liberalisation. When a multilateral trade negotiation was announced, efficient domestic producers (potential exporters) had leverage to persuade their governments to reduce protection in other countries by offering to reduce the tariffs protecting their own import-competing industries. The key to liberalisation was reciprocity. Efficient domestic producers (potential exporters) became the drivers for reducing tariffs. The second round effect was that as tariffs were reduced, efficient (export) sectors flourished at the expense of import-competing sectors, and economic efficiency improved in participating countries (Baldwin (2008)).

The GATT was available to facilitate orderly liberalisation of trade on a multilateral basis. At the same time, the countries of Western Europe were discussing closer economic integration. The break-through came in 1956 with The Treaty of Rome, which established the European Economic Community (EEC), according to GATT article XXIV.

It was at this stage that the GATT became appreciated. Until 1958, the GATT Contracting Parties had held four negotiating sessions to little effect, though many new members had joined. Once the EEC was announced, the US, Canada and other non-EEC countries realised that they were to be discriminated against in EEC markets. Western Europe was ‘at sixes and sevens’, because Britain and six (soon to be seven) neutral countries formed EFTA as a defensive measure in 1960.

The US response was to initiate a round of GATT negotiations in 1958, in an attempt to ameliorate discrimination arising from the EEC adjustment to a common external tariff. This “Dillon” Round achieved little, probably

because the EEC was preoccupied, while the rest of Western Europe was confused.

The creation of the EEC, however, had focused attention on the GATT and it promoted serious efforts towards trade liberalisation. The US wanted to ameliorate any discrimination that might come from EEC adjustment to a common external tariff and a common agricultural policy. The Kennedy Round (1963-67) achieved tariff reductions of 35 per cent (on average) for manufactures (with a few exceptions), but made no progress towards moderating the CAP<sup>10</sup>.

The 1960s saw sudden activity too, on trade policy for developing countries: first, The Haberler Report (1959) (which resulted in Part IV Trade and Development being added to GATT), and then UNCTAD (1964) set out developing countries problems and became a permanent UN agency.

The 1970s and 1980s followed a similar pattern to the 1960s. In 1973, the Tokyo Round negotiations began in GATT in difficult global economic circumstances; oil crisis, stagflation, and trade demands from UNCTAD III disrupted these negotiations. Tariff negotiations were successful again, with average reductions of around 30 per cent; but the negotiations were tied down over 'trade rules', where only moderate success was achieved. Developing countries were granted 'an enabling clause' to prolong their tariff preferences in developed countries' market. This 'escape clause' was to become a problem in the Uruguay Round.

The achievements of the GATT between 1958 and 1994 were remarkable. The trade negotiating process was in tune with industrial development requiring new markets to exploit new technologies in production, transport and communications. Most industrial tariffs in OECD economies were reduced, on average, by 30 per cent in each of the three GATT negotiations. (That amounted to more than 70 per cent average reduction in tariffs.) Globalisation spread prosperity and opportunity. Yet, this success gave way to an evidently 'second best' trade strategy after 1990.

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<sup>10</sup> The Common Market trade negotiations followed the standard course, with industrial protection reduced, but a delay between the commencement of tariff adjustments on industrial goods towards the CXT and an agreement on agricultural policy, which fostered high agricultural protection. This remains a keystone of the EU even today.

## **The Uruguay Round Crisis**

The 1980s opened with the global economy in recession and little thought of another round of GATT trade negotiations after the difficulties in the Tokyo Round (1973-79). However, the new Reagan Administration in the US saw trade negotiations as an instrument to advance its free-market philosophies, and as a counter to rising protectionist pressures at home. The United States, with different degrees of support from other OECD governments, proposed an agenda that went outside conventional GATT work programs, to include investment restrictions, trade in services and product counterfeiting, as well as emphasising agriculture. Above all, the 1982 GATT ministerial meeting called for a review of the functioning of the multilateral trading system. These demands led to a very difficult preparatory phase for the new round and serious differences among disparate contracting parties were exposed. It took four years of discussions, and some deceit, to get an agenda approved in September 1986 (Croome (1995)). Many bodies were buried along the road to agreement; some became ghosts that still haunt the WTO!

Eventually, the GATT Uruguay Round negotiations opened in 1987 in Geneva, when the world was still divided along Cold War lines. By 1989, however, massive political changes were occurring. 'Civil society' groups had achieved peaceful transfers of power in Eastern Europe as Russian forces returned home. The enlarged European Community successfully established the Single European Market (SEM) in 1989. These major changes came together and transformed Europe. The success of 'civil society' groups in Eastern Europe stimulated social groups in western countries to mobilise their resources more aggressively. Non-government organization (NGOs) burgeoned and international agencies became targets for anti-globalisation protests. In Eastern Europe, democratic governments found advantages in associating with western institutions. The newly formed EU-SEM was besieged with applications for membership, while Bretton Woods' institutions and UN agencies welcomed new and returning members.

These developments in Europe coincided with negotiating difficulties in the Uruguay Round negotiations. The long gestation of the Uruguay Round agenda (1980-86) had not facilitated negotiations. Tensions persisted in

traditional areas of GATT negotiations not resolved in the Tokyo Round (agriculture, TCF and non-tariff measures (safeguards, anti-dumping, export subsidies)). In addition, entirely new and unfamiliar subjects had been introduced onto the Uruguay Round agenda (trade in services, intellectual property rights, investment rules, quarantine, etc).

The mid-term review scheduled for 1988 exposed continuing controversy over the agenda, not least the confrontations over agriculture. A GATT ministerial meeting in Brussels (December 1990) was expected to sign off on an agreed text for the Round. However, a spectacular walk out by Latin American negotiators, after EU and Japanese negotiators had rejected an agreed text on agriculture, created a crisis that lasted almost four years. It sowed seeds of dissent that have continued to disturb trade negotiations.

Despite drawn out negotiations in the Kennedy and Tokyo Rounds, their foundation agreements on tariff reductions were achieved quickly, with only one or two sensitive industrial tariffs requiring specific attention. Most of the negotiating time was taken up with arguments about protection of agriculture, or defining GATT escape clauses (so-called trade remedies provided in GATT articles).

The Uruguay Round started in similar fashion with broad agreement on tariff reductions. The Brussels breakdown in 1990, however, caused a discontinuity. Non-OECD governments realised that the 'new' agenda items would be more difficult to deal with than traditional tariff negotiations. At the same time, OECD businesses realised that tariffs and border measures were no longer the principle impediments to their expansion in 'globalizing' markets. Successful growth strategies would depend on investment access, rights to compete, protection of intellectual property rights and trade in services rather than border access. When negotiations on agriculture broke down again, businesses put pressures on governments to pursue access to foreign markets in other sectors. Bilateral (or restricted) negotiations were evidently easier than multilateral negotiations on these sensitive issues. Attention turned to negotiating bilateral PTAs, which became the preferred instrument.

Political interests were also sympathetic to PTAs. Governments were under increasing pressure from NGOs and 'civil society' to protect labour rights and the environment, and assist development in poor countries. The EU had long favoured bilateral agreements with new members (neighbouring



countries, new applicants and ACP former colonies). President Clinton made bilateral trade agreements his instrument of choice, too. He declared these interests in the lead-up to the ill-fated WTO ministerial meeting in Seattle (1999). The return of Democratic control to The House of Representatives in Washington in 2006 saw these NGO issues come to the fore again in US trade policy (getting special mention in PTAs). However, since the Doha Round opened in 2001, US trade policy has received little attention from US Administrations for almost a decade.

Until the Uruguay Round, implementation of GATT obligations was not an issue. Any developing countries' participation was defensive and consistent with the Enabling Clause (1978). However, when the Uruguay Round was proposed many developing countries took an active role to pursue their export interests, including textiles and agriculture. For their part the OECD governments expected further liberalisation of industrial products, but they were also pursuing new commitments on services, intellectual property rights, investment access, etc. In reality, subsequent assessments suggest that the developing countries concessions (on tariffs and other border measures) imposed higher costs than the benefits from OECD abolishing the MFA (textiles) and its tariff reductions (Finger (2001)). GATT liberalization of border measures was quite different from WTO creating rules on domestic policies that impede trade (such as labour laws, environment restrictions, competition, etc). These latter issues were to become the substance of PTAs.

After the deception practiced in the Uruguay Round, it is small wonder that developing and middle-income countries are playing hard to get in the Doha Development Round. At the same time, OECD governments are actively pursuing PTAs<sup>11</sup>. The resulting chaos is dangerous and difficult to interpret.

### **Do PTAs conform to GATT/WTO provisions?**

It could be argued that trade preferences have been used since GATT was established because some key industrial sectors have been excluded from

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<sup>11</sup> NAFTA (1992); ASEAN-FTA (1992); EU membership increased from 12 to 27.

tariff dismantling; notably agriculture by US, EU, Japan and others; raw materials processing (highlighted in The Haberler Report (1958)): textiles, clothing and footwear (Multi-Fibre Arrangement (MFA) was adopted after UNCTAD III (1971)). The inclusion of preferential arrangements in a multilateral regime founded on non-discrimination, bound tariffs and negotiated liberalisation would be expected to provide a system of review to maintain consistency with prescribed conditions. However, the GATT was operated like a 'gentlemen's club'. Good behaviour was assumed!

Early in the 1960s, when GATT committees reviewed the regional agreements that had been introduced in Europe (EEC and EFTA), many questions of law and interpretation were raised, but reconciling economics, political intentions and treaty obligations proved too much for the committees. They were unable to reach verdicts. It was believed that too much interference in voluntary agreements according to GATT articles would weaken cooperation among Contracting Parties. So, although several other regional trade arrangements were being considered, the GATT was reduced to granting a waiver and advising that regional agreements should be kept under continuing review<sup>12</sup>. Unfortunately, PTAs were off the agenda for almost 30 years after that, so no further attention was given to their compatibility with GATT undertakings.

In 1995, the pressure for new PTAs forced the WTO to establish a new committee to review them. It was soon overwhelmed by notifications and no reports have been presented to the WTO Council<sup>13</sup>.

In July 2006, an announcement was made that the WTO Council had agreed on procedures to assess PTAs to establish their consistency with WTO rules. PTAs notified to the WTO would be considered according to a factual

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<sup>12</sup> Dam (1970) chapter 16 explains that GATT article XXIV is 'deceptive', because the underlying principles make little economic sense, and apparent precision in that article is illusory. What is meant by "a common external tariff" in a customs union? What is meant by 'substantially all trade'? etc.

<sup>13</sup> Newly independent East European and neutral countries sought access to the European Union; NAFTA came into effect in 1993; the six ASEAN countries formed an FTA in 1992; EU sought PTA arrangements with former colonies in Africa, Caribbean, and the Pacific; and new PTAs began to form in Africa and South Asia.

analysis drawn up by the WTO secretariat. Speaking in January 2007, Pascal Lamy<sup>14</sup> gave his assessments of the reasons for the growth of PTAs.

- Trade agreements were easier to conclude with fewer parties;
- Similar national interests allow progress ‘beyond-the-frontier’ into areas such as investment, competition policy, technical standards, labour standards and environment policies;
- Often geo-political considerations promote domestic reforms.

Lamy argued for “cohabitation” of bilateral and multilateral trade agreements, by harmonizing rules of origin and transparency. It was a pathetic surrender to PTAs, and showed little understanding of trade discrimination, especially when major trade sectors (such as agriculture) were left out. It comes as no surprise that three years later PTAs dominate trade relations – and that strengthening trade policy rules is well down the international agenda.

PTAs are now numerous and varied. The consequences of neglecting GATT’s ‘most-favoured-nation’ clause are difficult to assess; new instances of discrimination occur every day. Why after 30 years of acceptance and success were GATT principles cast aside?

### **Optimism misdirected**

The 1990s opened with optimism, especially in Europe where the EU ‘single market’ was launched, and liberation of Eastern Europe offered scope for expansion. The EU, however, is not a liberal market economy. In most EU countries, government expenditure accounts for more than 50 per cent of GDP, and that share is rising. For non-European OECD countries the ratio is less than 40 per cent. The CAP is strongly defended in any trade negotiation, including PTAs with developing countries, and agriculture is excluded from partnership agreements with Mediterranean economies on the EU’s southern flank. The negotiations with eastern neighbours after 1990 made some compromises on this policy that emphasised its permanence. Uruguay Round negotiations slipped down the agenda as bilateralism occupied the European trade agenda.

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<sup>14</sup> Speech by Pascal Lamy, Director-General WTO, delivered in Bangalore, India (January. 2007).

Thatcher and Reagan had retired by 1990. The first act of Clinton's Democrats was to endorse PTAs by approving NAFTA (with the addition of some 'new age' frills on labour standards and environment protection). The US drive behind the Uruguay Round had petered out after the breakdown of negotiations in December 1990. Anti-globalisation demonstrations and street theatre had replaced economic rationalism. PTAs became easier to manage than multilateral meetings. Moreover, bilateral agreements could include clauses on investment, competition, services, labour standards, environment, etc, all of which had become no-go issues in GATT/WTO negotiations.

The 1990s saw the US and the EU drift apart. EU expansion ignored GATT rules, while the US withdrew to deal with domestic problems and to open markets in South America for US companies.

“The EU is too defensive on agriculture and too offensive in trying to push dubious new regulations on environmental standards and labour standards.”

“Anti-dumping and rules of origin procedures in the EU are shrouded in secretive, discretionary and arbitrary behaviour, with restricted access to information.

(Razeen Sally, *New Frontiers in Free Trade*.)

US procedures on anti-dumping and agricultural policies are as disguised and protectionist as the EU, and US 'rules of origin' are very restrictive (see textiles protection in NAFTA). However, the US has been struggling with domestic socio-economic problems for more than a decade. The global financial crisis was exposed on Wall Street. Warnings had appeared earlier, only to be patched over until 2007-08.

The launching of the WTO Doha Development Round, in November 2001, appears to have been a political gesture after the New York Trade Centre bombing. US Administrations since 2001 have shown little interest in trade negotiations, while the EU has done its best to scuttle them. The new Obama Administration has shown no leadership on trade negotiations<sup>15</sup> (except for careless statements that US exports must increase!). In this trade vacuum, it is no surprise that PTAs are spreading, with the focus on 'beyond-the-

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<sup>15</sup> In March 2007, I met several advisers to new Democrats that had entered Congress after the 2006 election. They had no interest in -- or knowledge of -- trade. This typifies the new Administration too.

border' measures. The risks associated with PTAs are, apparently, acceptable – even if they are not measurable!

Developing countries also became infected with faith in PTAs. The rapid increase in WTO membership after 1990 raised membership above 150 countries. Unfortunately, this UN-isation has made it impossible for the WTO Council and its committees to reach decisions by consensus (especially, with the rise of UN-led 'global governance' infecting international agencies). Traditional GATT settlements among 'principal suppliers' in 'green room' bargaining have no place in this new WTO, which focuses on procedures and equity for the poorest members. As a consequence, bilateral decisions prevail. Only judicial committees, such as the Dispute Settlement Process, are able to act effectively.

Orderly international institutions have been replaced with committees of the willing, meaning like-minded governments. With no effective or acceptable global institutions, G-20 was established to deal with the global financial crisis (GFC) in 2008.

Trade policy across the world is unbalanced because it relies on PTAs. ASEAN is no exception. These ten disparate economies are entangled in a web of weak and partial PTAs. Non-tariff barriers are extensive and most PTAs omit agriculture, which means genuine integration is limited. Services are a trivial item in most bilateral PTAs, with movement of workers between countries limited, though cross-frontier investments are spreading slowly. The progress of integration is extremely uneven, with mercantile economies such as Singapore benefiting, while backward regimes such as Burma show little interest in economic activities. Vietnam and Thailand are active economies, while Indonesia and Philippines have poverty problems associated with population growth. The role of China is an enigma, but is the most crucial ingredient in the South-east Asia mix.

## **Specific questions on PTAs in the WTO**

### **1. Do PTAs contribute to reducing trade and investment barriers?**

Measuring benefits from a specific PTA is difficult if one or both of the participating countries have PTAs with other countries. Compiling estimates of trade creation and trade diversion for one country becomes impossible. Many other variables are in play, such as income and its distribution, competing suppliers (within the PTA and from third countries), advances in technology, etc. If trade increases over time there are many explanations that may not be related to a specific trade agreement. Measuring increases in bilateral trade flows over time may give satisfaction to governments, but with many variables affecting trade patterns, they tell us little about efficiency.

With different varieties of PTAs now operating, it is impossible to identify their economic effects. Apart from removing trade barriers, most PTAs relax some other border restraints, such as foreign investment rules, competition policy, government procurement procedures, labour laws and environment policies (to name a few!). Nominally these relaxations apply only to PTA partners, but in practice it is often difficult – and expensive -- to discriminate by source country. Such discriminatory tariffs or investment measures may enhance welfare in both countries, but third parties are likely to be affected adversely. An economic assessment should go beyond the effects on the two principal economies to consider welfare effects on the rest of the world.

The legal commitment and its enforcement is the prerogative of PTA negotiators, but broader economic considerations apply in assessing the effects of treaties. The proliferation of PTAs has made assessment of any particular treaty impossible. One country's PTA may favour its partner(s) but it discriminates against all other countries.

## 2. Australia's need to protect itself against new trade barriers.

There is no evidence that PTAs have prevented the introduction of 'new barriers'. Quite the opposite! Each new PTA that discriminates against outsiders amounts to new barriers against non-associated countries. If the only instrument of economic integration is PTAs, then by definition Australia cannot achieve such agreements with all its trading partners. Already Australia has been cold-shouldered by China, Japan and Indonesia, and by several other ASEAN countries. Australia has little to offer major economies because it has an open economy with few border restraints. Consequently, Australia has little leverage to open other economies using trade agreements, though an open trading stance has brought good returns.

By definition customs unions and free trade areas are discriminatory and they were included in the GATT as an exception to most-favoured-nation treatment on specific conditions. Between the first adoptions of regional integration using GATT article XXIV in Western Europe late in the 1950s (and in Africa in the 1960s), and the more widespread acceptance of PTAs in the 1990s, there was time to re-assess the consequences of PTAs. Trade between members increased (trade creation), at the expense of outsiders (trade diversion) as internal tariffs were reduced. This showed there would be winners among PTA members and losers among third parties that were discriminated against. A PTA is a step towards liberal trade but the distribution of trade benefits depends on many adjustments inside and outside the PTA<sup>16</sup>.

Over the past twenty years there has been an increase in multi-layered discrimination in world trade from the spread of 'hub-and-spoke' PTAs. The saving grace has been that many participating countries had reduced their multilateral trade protection substantially after four GATT rounds (1958-94).

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<sup>16</sup> Global trade liberalisation brings greatest gains in welfare. AFTA liberalisation among all members, rather than by bilateral agreements, would increase benefits to all members (see Robertson (2010 forthcoming)).

The principal exception remains agriculture<sup>17</sup>. PTAs are instruments of discrimination and experience shows that PTAs are preferred to multilateral liberalisation because negotiators are able to manipulate negotiations to exclude sensitive sectors. Agricultural protection has been virtually excluded from GATT negotiations since 1948, and it is similarly treated in PTAs. As far as the WTO is concerned, agriculture remains a no-go area. Very little has ever been achieved to moderate agricultural protection in GATT negotiations.

### 3. What role can PTAs play to support the WTO?

The closing years of the Uruguay Round negotiations suggested that leading countries in the GATT had forsaken multilateral negotiations in favour of bilateral agreements with middle-income nations and neighbours. After 1990, leading countries resorted to PTAs to get their way on ‘new issues’ not acceptable in the Uruguay Round negotiations. These extensions were not traditional GATT trade issues but ‘beyond-the-border’ domestic policies, such as investment rules, competition policy, government procurement rules and protection of intellectual property rights<sup>18</sup>. Many PTAs included to investment rules to allow access for foreign companies. (UNCTAD data shows there are over 5000 international investment agreements<sup>19</sup>.)

OECD delegations raised these four topics at the 1996 WTO Council meeting in Singapore. They were firmly rejected by developing countries’ delegations, but they remain an issue. More pressure is now exerted by OECD countries on labour standards and environment policies as conditions

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<sup>17</sup> High protection for agriculture in the EU derived from the nature of the Treaty of Rome. The EEC nations were required by GATT article XXIV to establish their CXT “not higher than an average of member tariffs”. Thus the European customs union harmonised industrial tariffs to an arithmetic average in 1958. However, the CAP was not settled until 1964 when agricultural prices had risen relative to prices of manufactures (which apart from being the average pre-CU tariffs had been reduced by at least 50 per cent by Dillon Round and EU harmonisation) and farmers were not prepared to reduce prices. This precedent has never been corrected. Moreover, US farm subsidies produce surpluses that make it politically inconvenient for US to negotiate on agricultural protection.

<sup>18</sup> The UN-World Intellectual Property Organization (WIPO) in Geneva administers patent and copyright law under the Berne Convention and the Paris Convention, respectively. Many governments still dispute whether the WTO should deal with infringements of these conventions (ie counterfeit goods).

<sup>19</sup> See *Trade and Assistance Review 2007-08* (Productivity Commission, 2009).



in PTA negotiations. These non-trade matters are more easily raised in bilateral PTAs than in the WTO. When re-introduced by OECD countries at the Doha Round Ministerial meeting in Cancun, in 2003, these issues almost caused a walkout by developing countries' delegations.

**4. Do PTAs facilitate adjustment to economic developments?**

There is no evidence to support or deny this. If partners get into difficulties, financial assistance may be provided, but this would be negotiated outside the trade agreement. For example, The Chiang Mai Initiative Multilateralization (CMIM), formalized in December 2009 and comprising ASEAN + 3 (China, Japan, Korea) was devised to assist if financial difficulties should arise, such as the 1997 ASEAN crisis. The CMIM took ten years to negotiate, which shows how much time it can take to progress new agreements in ASEAN.

**5. Have PTAs affected Australia's trade and economic performance?**

Latest estimates of Australia's trade with PTA partners do not show any unusual growth. However, apart from the long-standing Australia-New Zealand FTA, other PTAs (with Singapore, Thailand, United States and Chile) have only been effective since 2006. The global recession since 2007 makes it difficult to assess recent trade changes. (The ASEAN-ANZ free trade agreement, covering goods services and investment, was signed in February 2009 to take effect at the beginning of 2010.)

**6. Assess Australia's influence on regional trade and investment barriers.**

Australian governments have been active in seeking PTAs with countries in south-east Asia but most negotiations have been on hold for several years (eg Malaysia, Indonesia, Philippines, China, Japan, South Korea). It remains to be seen whether the ASEAN-ANZ FTA (2010) will advance Australian bilateral interests with individual ASEAN members. Countries such as Burma, Laos and Cambodia offer few opportunities.

However, some regional governments have proposed a schedule for an ASEAN Economic Community (AEC) to be achieved by 2015 (Hew (2008)). This defines an intensive regional integration among some very disparate economies. An ambitious program has been set, but it is unlikely that many governments are serious about the timetable. Many industrial

sectors are still outside the individual bilateral FTAs that link ASEAN economies together, and much of the growth in intra-ASEAN trade probably still relies on EANIC links from 1980s. It is worth remembering that PTAs not only create trade, they also divert trade from low cost to higher cost sources. These effects depend on tariffs before and after a PTA is formed. PTAs have mixed effects on efficiency and productivity.

7. Assess scope for future benefits from Australia's PTAs.

It is extremely difficult to assess benefits and costs associated with any second best strategy (see footnote 9 (above)). So far Australia has five significant PTAs. The Australia-New Zealand FTA is rather more than a PTA, for historic reasons. (Australia's relations with Papua-New Guinea and the Pacific Agreement on Closer Economic Relations (PACER 2008) are unusual responsibilities.) The USA-FTA is based on a political/defence relationship. That leaves just three bilateral PTAs where Australia is a full participant, with Singapore, Chile, and Thailand. These are unlikely to revolutionize Australia's trade, because this trade is already open and multilateral.

The openness of the Australian economy means that overseas traders do not need to seek special bilateral agreements. Hence, China, Japan and Korea do not need an access agreement with Australia, especially since Australia's agricultural sector could disrupt their heavily protected farm sectors. Australia's mineral exports are mostly competitively managed by international corporations using long-term contracts.

That leaves service sectors and exports of specialized high-tech. services and components. Services often depend on advanced education and know-how that is mobile as human capital. These may not need permission to work temporarily or permanently overseas (eg business management, ICT experts, engineers, marketing managers, etc). Access for foreign investment is being eased in many countries and self-interest is opening opportunities for foreign service providers. Formal agreements apply to traditional forms of trade, but service contracts need not be formal or require government approval. Seeking special access to markets using inter-government agreements was the mindset when GATT procedures were effective.

### **Mortimer Report (2008)**

This Report appears relaxed about the breakdown of GATT/WTO processes and accepts as inevitable the ASEAN spaghetti bowl of PTAs. Because Australia is seeking bilateral agreements with Asian economies, the report focuses on an assessment of ASEAN prospects. It is passive about bilateral PTAs and fails to mention the difficulties fitting ten separate agreements into a regional arrangement already comprising 45 bilateral treaties. In doing this, Australia has been competing for attention alongside three major economies -- China, Japan and Korea. Now the EU also is seeking PTAs in the region. In recent years, Australia's attempts to establish PTAs with ASEAN members have been fobbed off by several of the original ASEAN 6. (The latest rejection came from Indonesia in March<sup>20</sup>.)

Three of the four Mekong countries appear to be an impediment to ASEAN progressing towards a single market<sup>21</sup>. The military council in Burma shows no commitment to any international links; Laos and Cambodia are very poor; and Vietnam although a competitive exporter of manufactures, has a struggle between its communist political system and modern industrial development. It is interesting that Vietnam has reacted positively to an approach from the EU for a PTA.

The Mortimer Report pays little attention to the fractured nature of ASEAN, or the difficulties of linking ten disparate economies with Australia. Non-tariff barriers are more extensive in most ASEAN economies than tariffs.

The East Asian Community (EAC) proposal was made in 2003, with a target date for integration by 2020 (Hew (2008)). At the 2007 meeting, the date was progressed to 2015 with the adoption of the ASEAN Charter and an itinerary for economic integration. Progressing ASEAN regional cooperation remains dependent on 'consensus' decisions, which slow any integration.

All the ASEANS signed free trade arrangements with China in 2006. So far this has involved bilateral contracts between each ASEAN country and China, usually for material and component supplies to China. However,

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<sup>20</sup> On his official visit to Australia (11-13 March 2010), President Susilo Bambang Yudhoyono declared he was not interested in economic links with Australia. He said his attention was directed to strengthening economic links with AESEAN.

<sup>21</sup> Leung, Bingham and Davies (eds) (2010).

there is little evidence of liberal trade across frontiers. Japan has signed NEPs (new-age economic partnership agreements) with Thailand and Singapore, and more are under consideration. Korea (ROK) is also seeking PTAs in the region. ROK has recently signed a PTA with the EU, but the US-ROK PTA has run foul of the US Congress (over labour rights and exports of motor vehicles).

Australia has sought PTA negotiations with China, Japan and Korea in recent years, but seems to be well down those countries' business agendas.

The consolation prize for Australian negotiators seems to be the recently convened Trans-Pacific Partnership (TPP)<sup>22</sup>, which met in Melbourne in mid-March 2010. (Present were representatives of United States, Singapore, Australia, New Zealand, Chile, Peru, Brunei and Vietnam.) No progress was reported from this meeting, but it did incorporate the Pacific-4 (New Zealand, Chile, Peru, Brunei) and offered a Pacific alternative to ASEAN+3. However, free-trading Singapore and Brunei were the only ASEAN representatives; the Big Three (and most of the ASEANS) declined to attend.

It is questionable whether Australia can show much gain from PTAs or repeated reviews of trade policy agreements. Australia's major exports are managed and distributed by international companies in relevant markets. Governments and committees of officials produce well-meaning reports, but most produce a list of new committees to advise businesses that surely know their own industry. Chapter 10 in the Mortimer Report proposes:

- Eight new committees and more annual reports
- Expand *Austrade* to develop a 'trade advocacy strategy' (?)
- Bring export and investment issues to COAG!

These proposals require careful assessment to assess whether commitment of such resources is appropriate in the ASEAN context.

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<sup>22</sup> This kind of proposal was mooted by APEC-Business Advisory Council (2004) and C. Fred Bergsten (Director of Peterson Institute, Washington D.C.) in his study, **The United States and the World Economy** (IIE, Washington, D.C., 2005).

### **Mortimer: Recommendation 6.7**

**Consider the merits of negotiating a bilateral FTA with EU, including an agreement that is focused only on services and related investment.**

This approach was tried and failed in 1996. The Australian Government sought a Framework Agreement on Trade and Cooperation with the EU. The EU required that Australia should adopt *The EU Charter of Fundamental Social Rights of Workers*, which had been signed in Strasbourg in December 1989 as part of the *Maastricht Treaty*. When the Australian Government rejected this extraterritorial interference in national affairs, the agreement was relegated to *The Joint Declaration on Relations between the European Union and Australia (1997)*, which amounted to nothing. The EU has added many other legal requirements since 1996 that are unlikely to be acceptable to the Australian Authorities<sup>23</sup>.

### **Why PTAs are dangerous**

It is 15 years since the Uruguay Round was completed and 8 years since the accident-prone Doha Development Round began. The gap is being filled by weak PTAs that are claimed to substitute for WTO agreement. These documents created in tedious meeting rooms across the world provide media-moments for trade ministers but get little critical assessment from the press, opposition parties or trade experts.

PTAs are protectionist, because they discriminate against outsiders and most imports are not derived from the most efficient low-cost source. The imports from a PTA partner are likely to be available more cheaply from elsewhere if, before the PTA preference was granted, they were purchased from another source. Proof of this distortion is immediately apparent by reviewing some of the world's largest bilateral trade flows. US-China trade and US-EU trade are not covered by any bilateral agreements, yet these are the largest trade flows. On the other hand, China, Japan and Korea show little interest

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<sup>23</sup> D. Robertson (2002) "The European Union and Globalisation" in C. Saunders and G. Griggs (eds), **Trade and Cooperation with the European union in the New Millennium** (Kluwer Law International, UK).

in PTAs with Australia, because their exports to Australia are subject to few tariffs. On the other hand, Australia's agricultural exports to these countries are heavily restricted!

Simple PTAs show little evidence that they promote efficient trade. If bilateral trade does increase after PTA adjustment of tariffs, it will probably be trade diversion because of the preference granted over the original source<sup>24</sup>. The reasons for this trade diversion may be political, defensive or strategic, but not economic. Moreover, the increased trade may be temporary or strategic. A PTA may be associated with long-term contracts or investment commitments. However, these refer to specific circumstances and would not account for PTAs becoming commonplace.

### **Legal drafting and trade practicalities**

Systemic trade problems, such as rules of origin, antidumping or agricultural protection, are not susceptible to resolution in PTAs. These require global solutions, preferably in the WTO. Selective liberalisation with one or a group of trade partners in a PTA generally discriminates against the trade of outsiders. By creating legal systems to support PTAs institutional barriers are created.

PTAs complicate the trading system by inter-weaving different trade flows rather than facilitating exchange. A carefully drafted bilateral legal agreement between two countries may not integrate easily with similar agreements with third parties. Interpreting such contracts is likely to be presented to customs officials at point of entry or exit on a frontier. Only ten per cent of intra-ASEAN trade is estimated to cross borders with PTA preferences, and one reason for that is clerical ignorance of all the relevant bilateral agreements. Lawyers spend much time perfecting inter-government agreements, but it is unlikely that they supervise their implementation in practice.

Officially, Australian reactions to PTA proposals are treated as desirable from a regional perspective. However, Australia has a limited choice of PTA partners, and recent approaches in East Asia have shown little return.

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<sup>24</sup> Pascal Lamy (D-G, WTO) is reported to have said, "The reality is that bilateral PTAs have a political advantage. If you are a politician and you want to increase your brownie points domestically, bilateral agreements are good." Lamy was a French politician!

Though it is early days, some enthusiasm from other ASEANs would be nice. So far, only neighbouring 'free traders' have responded willingly (Singapore, Thailand, and more recently Chile). Given Australia's liberal import regime, there is little to create urgency from trade partners. And exports of primary products and services face few restrictions in most markets. Only agriculture and processed foods offer market gains from freer access to Asian markets, and that would go against the interests of local farmers.

Australia has a difficult task getting into East Asia, as it does getting treated seriously in Europe. In OECD, it helps that there are six other non-European as full members. Even so, OECD Europeans go their own way. Their extra-territorial charges into international regulation (eg the precautionary principle, the Cartagena Protocol, GM food regulation, REACH (Registration, Evaluation and Authorisation of Chemicals), etc) will elicit strong responses from China and India eventually.

Australia can do little more than it has done to promote the WTO and the international trading system. Australia has low or zero tariffs on many imports. The Productivity Commission has several times recommended programs to deliver zero or low tariffs on passenger motor vehicles and the TCF industry, the only remaining industries with significant tariffs. However, governments have chosen to ignore this advice. There seems little more to be done. At the same time, ASEAN neighbours have shown little interest in Australia's approaches in recent times. It seems churlish to press unwilling partners.

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