

## **Bilateral and Regional Trade Agreements**

### **Productivity Commission Draft Research Report, July 2010**

**Comments from Ken Heydon** (Visiting Fellow, London School of Economics; Visiting Fellow, Sciences Po; former Deputy Director for Trade, OECD.)

#### **General Comment**

The report is commendably comprehensive. It makes a valuable contribution to the policy debate on preferential trade agreements (PTAs), combining rigorous empirical analysis with useful direct input from business interests.

The report could, however, be strengthened. Notwithstanding the cautionary notes contained in the study about the downsides of PTAs, the negative aspects of preferential arrangements could be brought out more sharply and the overall assessment of the relationship between PTAs and the multilateral trading system more firmly stated.

The comments below deal with the Draft Report's treatment of the downsides of preferential agreements. They start with two brief comments on citations from Heydon and Woolcock 2009, and conclude with an observation about the broad policy lesson that might be drawn from the Report.

#### **US Agreements**

The Report (page 5.10), citing Heydon and Woolcock 2009, refers to positive features of the treatment of services in US PTAs. The study cited, however, also refers to the widespread tendency in US agreements to use negative-list reservations to exclude services measures maintained at the sub-national level and is generally sceptical of the self-proclaimed "gold standard" quality of US agreements.

#### **Impact on Economic Growth**

The Report (page 8.5) cites a passage from Heydon and Woolcock 2009 that observes that the picture from ex post analysis is mixed enough that it is not possible to conclude whether trade diversion has been a major problem. The cited passage goes on to say, however, that most of the studies using growth regressions suggest that PTAs have had little impact on economic growth.

#### **WTO-plus**

The Report (page 6.17) states, with a positive implication, that many of the issues addressed in BRTAs are WTO-plus in that they are beyond the scope of issues considered within the multilateral WTO framework. It would, however, be appropriate here to acknowledge that WTO-plus does not necessarily mean "better". This would also be consistent with comments elsewhere in the Report about the potentially negative effects of provisions dealing with core labour standards (for example, pages 11.6, 13.22), or overly strict protection of intellectual property rights (for example, pages 10.5, 11.6, 13.15).

It could also be acknowledged that there is the additional danger that the inclusion in PTAs of provisions dealing with controversial issues such as core labour standards will have a dampening effect on multilateral efforts at trade liberalisation should it be feared by developing countries that such inclusion will spread to the multilateral agenda.

### **Services Liberalisation**

It is stated in the Report (page 6.8) that in many cases, services chapters in BRTAs do not lead to preferential arrangements for partner countries. This is not the case however when mutual recognition agreements are involved. This is an important qualification given the widespread use of MRAs and the importance of services trade in the overall impact of preferential agreements. It is estimated, for example, that some 70% of EU gains from the pending EU-Korea FTA are attributable to the liberalisation of trade in services (*Economic Impact of a Potential Free Trade Agreement between the European Union and South Korea*, Copenhagen Economics, 2007).

### **Preferential Agreements and Regional Cooperation**

The Report (page 10.11) states that there has been little empirical research to shed light on whether or not BRTAs promote economic integration. While this is true, there must be a strong presumption that in the case of regional integration they do not. In Africa, the conclusion of bilateral agreements (now the norm) between the EU and selected members of African regional groupings is serving to weaken regional cooperation and integration. The ASEAN Free Trade Area is essentially a permutation of separate bilateral preferential agreements amongst the members, with complex rules of origin such that only some 10% of intra-ASEAN trade receives preferential access. The China-AFTA PTA follows the AFTA model, with each ASEAN government signing a bilateral trade agreement with China.

### **Coverage and the Scope of Liberalisation**

In section 11.3 of the Report there is discussion of the drawbacks of using BRTAs as a way of reducing own-barriers to trade and investment. A principal drawback, not mentioned in this section, is that it is easier to exclude sensitive sectors in bilateral agreements between hand-picked partners than it is in a broad-ranging multilateral negotiation that seeks to address the diverse concerns of all the participants. A case in point is the bilateral agreement between Switzerland and Japan where there is a shared inclination to yield to the strong domestic farm lobby.

### **Measuring the Gains**

The measurement techniques used to assess the impact of PTAs can both understate and overstate the potential gains. A common observation is that the modelling approaches used are not well suited to capture scale effects arising from the reduction of non-tariff barriers, pro-competitive action and stimulus to innovation and productivity, and hence tend to underestimate the intra-industry responses and dynamic adjustment to economic integration. Similarly, the assumption in much modelling work of a fixed supply of labour will tend to understate the gains from Mode 4 liberalisation of trade in services.

These observations apply equally, however, to the measurement of gains from multilateral liberalisation, and it must be concluded that, on balance, the measurement of the effects of PTAs tends to overstate the potential gains. This is broadly the conclusion of the Report, but additional factors, not covered in the Report, can be invoked in support of this observation.

- The understandable practice of focussing assessments on the impact of PTAs on the signatories to the agreements (as reflected in sections 6 and 7 of the Report) tends to understate the impact of negative effects on third parties.
- The exclusion from baseline scenarios of the effects of a successfully concluded DDA (perhaps not too optimistic in the 10-year time frame of PC analysis) tends to exaggerate the difference between MFN tariffs and, lower, preferential tariffs and so overstate potential trade creation (while also overstating the risk of trade diversion). There is a drafting point associated with this observation. On page 8.6 of the Report, in the third paragraph, the words “Conversely, with low tariff levels and” should be deleted.
- Likewise, the exclusion from the baseline of the effects of other agreements in the pipeline will tend to overstate the gains from a pending PTA.
- Whether the letter of a negotiated agreement is observed in practice will depend critically on the way in which the agreement is implemented. For example, in any agreement with Korea, the outcome will depend on the willingness and ability of the Korean government to reform the practices of the Chaebols.
- And the realisation of potential gains from market opening will also depend on the supply capacity of the exporting company. This cannot be assumed to be perfectly elastic.

### **PTAs and the Multilateral System: Not an Alternative**

The Report rightly observes (section 6.2) that PTAs can act as both building blocks and stumbling blocks to broader, first-best, multilateral liberalisation. But no reconciliation is offered of this apparent contradiction, apart from the rather lame observation (page 6.17) that the outcome will depend on the nature of particular agreements. There is, however, a basis of reconciliation, which, in turn, has an important policy implication. Preferential agreements can complement the multilateral trading system but only if that system is itself robust – strengthening trade rules and bringing down MFN barriers so that the distorting effects of PTAs are held in check. Only with a strong multilateral trading system will it be possible to make multi-level diplomacy work, whereby PTAs help implement and possibly extend WTO rule making in areas such as TBT/SPS or trade remedies in between multilateral rounds of negotiations or in parallel with a continuous work programme at the WTO. If we accept that PTAs and the multilateral trading system will have to coexist, the basis of this coexistence must be the continued strengthening of multilateral rules and disciplines under the WTO (Heydon and Woolcock, page 260).

Without a strong multilateral trading system there can be no hope of simply multilateralising PTAs through a supposed “domino” process (page 6.18) because of the effect of preferential agreements in creating a plethora of conflicting rules and generating vested interests against MFN liberalisation.

It follows that PTAs cannot be an alternative to the multilateral WTO process. It is therefore unfortunate that, notwithstanding frequent acknowledgements of the primacy of multilateral approaches to trade liberalisation, there are numerous references in the Report to PTAs as an alternative to such approaches. For example:

- ...it is not clear that the WTO, and the negotiation processes it administers, remain best placed to advance the international trade liberalisation agenda (page xxi).
- The Australian Government should consider pursuing bilateral and regional trade agreements to reduce foreign barriers to trade and investment when alternative channels, including plurilateral and multilateral means, are not practicable...(page xxvii).
- BRTAs offer an alternative to multilateral negotiations as a means of reducing barriers in other countries...(page 11.4).
- Against the backdrop of limited progress in multilateral negotiations, BRTAs are a feasible option for seeking the reduction of trade and investment barriers in other countries (page 11.9).

Moreover, the dangers of seeing PTAs as an alternative to multilateral approaches would be compounded were the Final Report to endorse the support expressed in the Draft Report for a more flexible approach by Australia to the comprehensiveness of the BRTAs it pursues (page 13.8). The conclusion of PTAs in which “more sensitive issues” are set apart would only serve to underline the importance of parallel, multilateral, efforts to address those sensitive sectors.

In conclusion, while the Report is correct in saying that the involvement or otherwise of Australia in BRTAs will have little effect on the extent of the global proliferation of bilateral and regional agreements (page 6.19), it is not correct in then concluding that the effect of BRTAs on multilateral trade liberalisation is for Australia a moot issue (page 6.19 and 6.23). It is in the interests of Australia and of all trading countries to acknowledge that PTAs are worthy of support only when they are accompanied by concerted efforts to strengthen rules and improve market access on a multilateral basis.