Volume 15 Number 2 2014/p.179-186 www.usask.ca/esteyjournal

The Estey Centre Journal of
International Law
and Trade Policy

Madly Off in All Directions – The Pursuit of Preferential Trade Agreements by North American Governments

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The article explores the reasons that governments in North America are engaged in negotiating preferential trade agreements with some of their most significant trading partners. Lack of progress in the Doha Round of the World Trade Organization provides the major incentive to find alternatives to broad-based multilateral progress in trade liberalization. Differences in both the ambition and the constraints associated with preferential agreements relative to multilateral rounds are explored. The results suggest that there are both potential benefits and potential losses associated with pursuing preferential agreements.

Keywords: multilateral, negotiations, preferential agreements, Trans-Atlantic Trade and Investment Partnership, Trans-Pacific Partnership

Introduction

The Canadian Council of the International Association of Agricultural Economists (IAAE) hosted an organised symposium at the 2013 Canadian Agricultural Economics Association/Agricultural & Applied Economics Association joint meeting in Washington, DC in August, 2013. The session was titled "Madly Off in All Directions – The Pursuit of Preferential Trade Agreements by North American Governments" and included the following presentations: "A Transatlantic Free Trade

Deal: Implications for Food and Agricultural Policy", "North American Agricultural Trade Policy: Are Super-Regionalism and Deeper Regional Integration the 'Next Big Thing' after NAFTA?" and "Erosion of Preferential Access and Market Access for Sensitive Products: The Evolving Dynamics of Agriculture in the TPP Negotiations". Each presenter was asked to discuss the prospects and implications of preferential trade agreements[1] (PTAs) that have been or are currently being pursued by Canada, the United States and Mexico. This special section of *The Estey Centre Journal of International Law and Trade Policy* features articles based on two of those presentations. (The third presentation, "Erosion of Preferential Access and Market Access for Sensitive Products: The Evolving Dynamics of Agriculture in the TPP Negotiations" is based on an article (Kerr, 2013) that was previously published in this journal.)

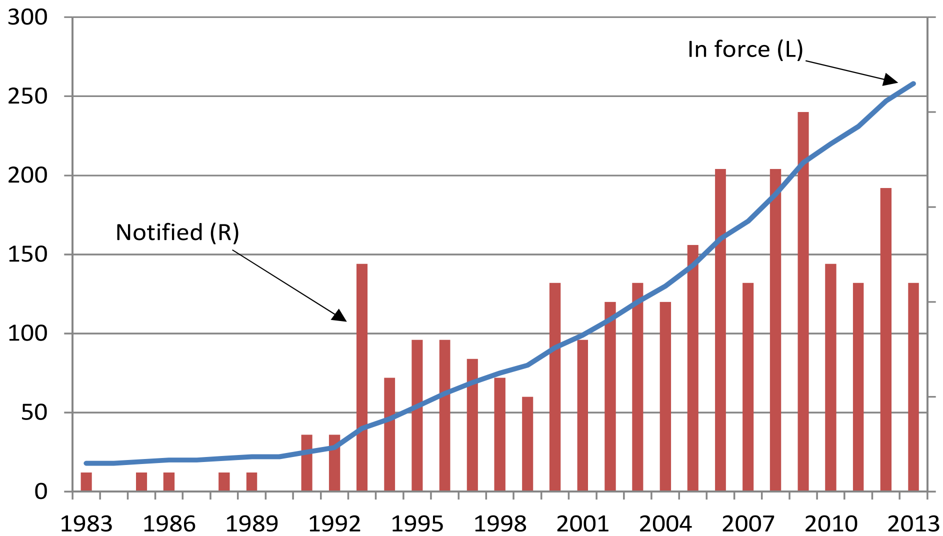
This introductory article outlines some of the important issues related to the expansion of PTAs, including the drawbacks of PTA proliferation compared to progress on multilateral trade agreements, specifically the agreements of the World Trade Organisation. The PTAs discussed in the related articles include negotiations on some of these topics, but other important issues remain outside the purview of most PTAs. These limitations of PTAs reduce the benefits of increased international trade in two important ways: first, the gains from trade in PTAs are confined to member countries, and nonmember countries can actually lose through trade-diversion effects. Second, some important trade-distorting policies (most importantly domestic support) that are liberalised in multilateral agreements are typically left out of PTAs.

What Explains the Pursuit of Preferential Trade Agreements?

The past 20 years have witnessed rapid growth in the number of PTAs (figure 1). These agreements range from bilateral, partial-scope agreements that only cover trade in specified goods, to customs unions between several countries that cover trade in most goods, services and investment.

Such growth is in stark contrast to the stalled progress of multilateral negotiations in the Doha Development Agenda (DDA), and the push by many countries to pursue PTAs can be understood as governments' responses to frustration with the lack of multilateral progress. A comprehensive DDA deal does not appear to be forthcoming, so countries seeking to expand their export markets have instead turned to alternative agreements with smaller groups of trading partners. Without getting into the specific disputes that have derailed the current DDA round (see Martin and Mattoo (2011) for discussions of these disputes), there are several obstacles that countries encounter when negotiating multilateral agreements relative to smaller PTAs.

Figure 1. Regional trade agreements notified to the GATT/WTO and in force



Krugman (1993) outlines four important obstacles. The first is that the large number of participants in multilateral negotiations complicates the determination of new disciplines by requiring the establishment of formal rules that can be applied uniformly to all members. Smaller PTAs with fewer members simplify these problems.

Second, multilateral negotiations are often bogged down by the determination of methods to convert non-tariff barriers into *ad valorem* tariff barriers. This process is fraught with difficulties and often results in countries adapting their existing non-tariff barriers so that their policies comply with obligations but still impede trade. This is particularly true when trading partners employ markedly different regulatory approaches in efforts to skirt the obligations made under multilateral agreements.

A third factor is the diminished power of the United States to dictate terms in multilateral negotiations. The increased influence (both political and economic) of emerging markets such as Brazil, China and India means that there is no longer a hegemonic power at the table, and that bargaining power is more dispersed among member countries. The divergence of the United States and the EU on several important policy issues has further dispersed bargaining power at the WTO.

A fourth factor that complicates multilateral negotiations relative to smaller agreements between fewer countries is the nature of competition within member countries' home markets. Countries that are characterised by markets that would not be made more accessible by reducing tariff barriers (because of, for example, domestic cartels) may not be able to offer anything to potential trading partners in the negotiation process. This problem is magnified as the number and heterogeneity of countries involved in negotiations increases.

Preferential Trade Agreements vs. Multilateral Liberalisation: The Bad News

Perhaps the most important negative consequence of the movement away from multilateral liberalisation, and towards PTAs, is the value of forgone benefits. Several studies (e.g., Hertel and Winters, 2006; Anderson et al., 2011) have estimated large income gains across WTO member countries if a multilateral deal were to be reached, and these gains are expected to reduce poverty in many low-income countries. Several developing and least-developed countries are members of PTAs through which they can derive some gains from trade; however, many of these PTAs are comprised of regional countries that are at similar stages of economic development (e.g., Southern African Development Community, Arab Maghreb Union, South Asia Free Trade Area). Most of the economic gains from multilateral liberalisation that are expected to arise in developing countries would come from improved access to markets in industrialised countries. The current wave of PTAs will not provide such access. Of the agreements discussed in this section, the TPP has the most potential to grant a few developing countries improved access to industrialised-country markets because it includes developing-country members (Malaysia, Mexico, Peru and Vietnam) and developed-country members (e.g., Canada, South Korea and the United States).

A related issue is that countries left out of these PTAs not only forgo the benefits of improved market access to other member countries but also could lose export market share as the result of trade diversion. Viner (1950) describes how imports from a (potentially high-cost producing) PTA member could displace imports from a (low-cost producing) nonmember country because the improved market access for the PTA member country more than offsets the production-cost advantage of a nonmember country. Trade diversion effects can be significant and can reduce, or even eliminate, the welfare gains that would typically be expected to arise from trade liberalisation. This is because PTA member countries may end up importing from other PTA members instead of other countries that have competitive production advantages.

Multilateral trade negotiations are typically characterised by concessions on a range of trade-distorting policies including market access, domestic support and export competition. The ongoing DDA negotiations over agricultural trade liberalisation include “pillars” devoted to each of these policy categories. Preferential trade agreements are typically not so broad, however, and tend to focus on the market access pillar. This means that subsidies provided to producers in many countries will not be subjected to new disciplines as a result of the current wave of PTAs. This issue is particularly important in agricultural production, where many OECD countries provide lavish subsidies to domestic producers (see Anderson et al. (2008) for comparisons of assistance to producers in developed and developing countries). These subsidy policies distort global production and trade patterns in a manner that favours producers in relatively rich countries that can afford to subsidise producers. As PTAs do not liberalise these policies, trading partners (typically the lowest-income countries) are left competing with subsidised production from developed countries. Likewise, export competition policies are also left out of most PTAs, meaning that countries that do not subsidise exports are left competing with subsidised products from high-income countries.[2]

As the number of PTAs grows, many countries belong to several different agreements and are faced with overlapping and complicated rules-of-origin for their exports. Bhagwati (1995) describes this phenomenon as the “spaghetti bowl” of countries’ myriad connections through their PTAs; the higher the number of connections, the higher are the trade costs of complying with and enforcing different regulations with trading partners under different PTAs. The TPP negotiations have included proposals to harmonise rules-of-origin between member countries in an effort to reduce these costs, and Zahniser and Moreno (this issue) argue that because most agricultural products traded within the NAFTA market use inputs that are sourced in NAFTA countries, such concerns are lessened. However, the same cannot be said about other recent PTAs, such as the Comprehensive Economic and Trade Agreement (CETA), in which trade costs may increase for products that are exported from Canada to the EU and are comprised of inputs from (for example) Mexico. The WTO eliminates many of these trade costs by aggregating many countries under one umbrella and conferring most-favoured-nation (MFN) status on all members. Products from every member are faced with the same tariff rate.[3]

Preferential Trade Agreements vs. Multilateral Liberalisation: The Good News

Because PTAs involve fewer countries, the liberalisation of some trade barriers can be more tractable than would be the case under multilateral negotiations. One example is the attempt by the United States and the EU to converge on (though not harmonise) some food regulations in negotiations for the Transatlantic Trade and Investment Partnership (T-TIP), as discussed by Josling (this issue). NAFTA member countries have also increased “regulatory cooperation” in recent years (Zahniser and Moreno, this issue). Regulatory barriers can be significant obstacles to international trade, and can be more restricting than tariff barriers for some food products. Such convergence may markedly increase trade flows between PTA member countries. Note, however, that regulatory barriers to food trade reduce exports from developing countries to OECD countries to a greater degree that intra-OECD food trade (Disdier, Fontagne and Mimouni, 2008). This means that the low-income developing countries that are not party to the PTAs discussed here will miss out on such gains.

Preferential trade agreements can also have significant effects on foreign direct investment (FDI) through direct and indirect channels. The direct channels include liberalisation of foreign investment restrictions and protections for foreign investors that go beyond those offered under WTO agreements. The CETA, TPP and T-TIP include investment provisions that will liberalise investment flows between PTA member countries further than has been proposed in DDA negotiations. Preferential trade agreements can also affect FDI flows indirectly by modifying firms' incentives to undertake FDI. Direct investment in foreign markets is often used as a method to gain access to a market without having to overcome tariff barriers. When the structure of tariff preferences changes through a PTA, firms' incentives to invest directly in the consumer market may change (Ghazalian and Cardwell, 2010). For example, when two countries enter into a new PTA that lowers tariff barriers, the incentives for a firm in either of those countries to undertake FDI in the other are reduced. These effects have been found to be significant in some cases (e.g., Baldwin, Forslid and Haaland, 1996).

A third important benefit of the current wave of PTA negotiations, particularly given the moribund state of DDA negotiations, is the potential for such agreements to serve as plurilateral agreements that induce more countries to join in the future. Also, such agreements could serve as templates for future multilateral agreements (as NAFTA did for past WTO agreements). This issue has been debated in the trade literature since Bhagwati (1991) investigated whether PTAs are "building blocks" or "stumbling blocks" to multilateral liberalisation. Josling (this issue) argues that the T-TIP negotiations have potential to act as a building block because negotiators are addressing issues that have been left off the DDA agenda (e.g., competition and investment). Though not a replacement for multilateral deals, Josling argues that these negotiations could re-energise multilateral trade negotiations.

Conclusions

The pursuit of closer ties with trading partners by Canadian, U.S. and Mexican governments is not surprising given the failing state of DDA negotiations. The lack of any tangible progress at the most recent ministerial meeting in Bali has left many observers feeling pessimistic about the prospects for a comprehensive multilateral deal.

It is also not surprising that the negotiating partners in these agreements are mostly high-income countries (with the exception of a few countries engaged in the TPP negotiations). Governments in Canada, the United States, the EU and Japan are beholden to strong domestic producer interests when making deals, and these countries have been willing to overlook each other's protections for sensitive markets in return for reciprocal leeway on their own sensitive markets. The focus is then placed on other areas in which agreement can be reached. The exclusion of such distorting policies may not be tenable when negotiating with developing countries such as Brazil, China and India, who may demand more significant liberalisation in sensitive areas in exchange for opening their markets to products from developed countries. This dynamic is unfortunate, because the gains from trade increase with the degree of heterogeneity of countries that liberalise trade with each other. The gains to Canada, the United States and Mexico of investing more deeply in PTAs could be significant, but will not rival those of a comprehensive multilateral trade liberalisation agreement.

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Endnotes

[1] A note on terminology. We use the phrase "preferential trade agreements" instead of "regional trade agreements" because many of the agreements discussed in this section include countries that are not in the same geo-economic region.

[2] Some PTAs include disciplines on export restrictions, but these disciplines only apply to exports to other PTA member countries.

[3] Countries within PTAs can face tariff rates below MFN rates with other PTA members.