



OVERVIEW

Free Trade Agreements: Boon or Bane of the World Trading System?

JEFFREY J. SCHOTT

Economists have long argued the costs and benefits of preferential trading arrangements (PTAs)—notably customs unions and free trade agreements (FTAs)—and their impact on the world trading system. Jacob Viner (1950) sparked this debate with his classic study, *The Customs Union Issue*; subsequently, James Meade, Richard Lipsey, Paul and Ronald Wonnacott, Jagdish Bhagwati, and others have built an extensive literature on the complex effects of PTAs on economic activity both within and between countries.¹ This chapter is not meant to survey this rich body of work. But it is worth noting that the general conclusion from these economic studies is that it is clearly preferable to negotiate in a multilateral forum and implement reforms on a most favored nation (MFN) basis. Moreover, unilateral liberalization of trade is usually even better, even without reciprocal “concessions” from trading partners.

At first blush, PTAs seem antithetical to the core principles of the post-war multilateral trading system. The General Agreement on Tariffs and Trade (GATT) has a golden rule, set out in Article I, to “do unto others as you do to your best trading partner.” In GATT jargon, this obligation requires a country to accord unconditional MFN treatment to the trade of all other contracting parties to the GATT. However, the original drafters of the GATT carved out specific exceptions from the MFN obligation for

Jeffrey J. Schott is a senior fellow at the Institute for International Economics.

1. For a political economy survey of the key findings in this area, see Bhagwati (1993) and Frankel (1997).

existing preference schemes, such as the British system of imperial preferences (dating back to the Ottawa Agreements of 1932) and the special US tariff arrangements with Cuba and the Philippines (GATT Article I:2), and for customs unions and free trade areas (GATT Article XXIV).² More recently, the General Agreement on Trade in Services (GATS) established comparable exceptions for service industries in regional integration arrangements (GATS Article V).

In fact, the postwar trade regime—reflecting a lingering mercantilist ethic—sanctions discriminatory treatment via a number of policy instruments. Some GATT provisions allow members to impose selective protection to counter “unfair” trade practices such as subsidies and dumping; others permit preferences for intraregional trade covered by customs unions and FTAs that eliminate barriers on “substantially all” trade between the partner countries. However, the GATT requirements that allow MFN exceptions are vague and have been abused. For example, agreements notified under GATT Article XXIV often exclude important sectors like agriculture, or overlook increased protection against third-country suppliers via restrictive rules of origin. Under both the GATT and the World Trade Organization (WTO), monitoring of such agreements has been notoriously lax. Indeed, a large number of FTAs receive no scrutiny at all because the agreements have not been notified to the GATT/WTO.

GATT negotiators attempted to rectify these shortcomings in the Uruguay Round but failed. The current Doha Round is again charged with this task. To date, however, little has been done. Reform proposals have been inhibited by what I call the “glass house syndrome”—virtually all WTO members are party to some type of regional agreement, and thus don’t want to throw stones at other pacts lest their own preferential deals come under attack. As a result, the trading system has treated FTAs with benign neglect. GATT/WTO obligations regarding regional arrangements continue to be dead letters.

Have trade officials been too complacent in their handling of FTAs in the GATT and WTO? Or have economists been too harsh in critiquing regional trading blocs and their threat to the multilateral trading system? Or have both practitioners and academics been too inflexible in their approaches?

To put it another way, are FTAs a boon or are they a bane for the WTO? Do they promote trade liberalization and reinforce multilateralism, or do they detract from and obstruct WTO initiatives and present an alternative to the WTO regime?

Not surprisingly, I find that there are no definitive answers to the questions posed above. The assessment depends importantly on how the FTAs

2. Interestingly, the original draft of the GATT covered exceptions only for customs unions and did not mention FTAs, which were added to the GATT during a substantial rewriting of these provisions at the 1946–47 Havana Conference (GATT 1994, 785–88).

4 FREE TRADE AGREEMENTS

are crafted and the volume of trade covered, who participates, and whether significant progress on multilateral reforms proceeds in tandem in the WTO.

In the following sections, I first examine the growing number of FTAs in the world trading system. I then assess whether concerns about the impact of proliferating regionalism on the WTO are justified, weighing the benefits and drawbacks of these preferential trading arrangements to the multilateral system. I conclude with a few concrete recommendations for WTO reforms that would mitigate some of the potential WTO problems posed by FTAs and, I hope, ensure that FTAs are compatible with and reinforce the objectives of the multilateral trading system.

FTAs in Current Context

Over much of the 55-year history of the GATT and WTO, regional trading arrangements have been a sideshow in international trade relations (with the notable exception of the agglomeration of the European Union). Until the 1980s, such pacts were a distinctly European neighborhood affair, with a few notable and mostly failed ventures at regional integration by small groups of developing countries.³ None of these arrangements was constrained by GATT obligations. The European deals were accepted in deference to broader security concerns, because they helped to build a stronger and more unified European Community against the Soviet threat; the developing-country pacts didn't matter, because those countries didn't undertake significant GATT obligations. Of the pacts notified to the GATT, only a few were deemed consistent with GATT obligations, but none was ruled inconsistent. Most were put in an obscure legal limbo in which countries reserved the right to take future action against alleged abuses.

Overall, European integration has been a resounding success. The European Community has gradually expanded from 6 to 15 countries (and will increase to 25 in May 2004), deepened its integration to develop an as yet incomplete single market, and extended trade preferences to a large number of neighboring countries and former colonies. In contrast, South-South regional pacts generally failed—in part because of their focus on import-substitution policies.

Over the past two decades, regionalism has changed dramatically—involving more countries (especially the United States), linking developed and developing countries in reciprocal trading arrangements, and spreading beyond local neighborhoods to connect trading partners across continents. The biggest policy shift has occurred in East Asia, where until

3. These PTAs took various forms—from “simple” cooperation arrangements, which covered the regulation of border barriers to trade, to FTAs and customs unions.

recently Japan, South Korea, and China had totally abstained from regional trade arrangements. These countries are now engaged in talks with each other and with the members of the Association of Southeast Asian Nations (ASEAN). In addition, South Korea has negotiated an FTA with Chile, and Japan has concluded an FTA with Singapore and is finalizing a pact with Mexico.

Several factors explain this new interest in regionalism by East Asian countries. First, the incremental integration of China into the regional economy has simultaneously created new opportunities for trade and investment in a huge, underdeveloped market and fierce new competition from China-based producers. China is rapidly becoming Korea's top trading partner and hosts substantial Korean and Japanese foreign direct investment. Second, Korean and Japanese trade initiatives reflect growing concerns in those countries about the drift in multilateral negotiations and the prospects for achieving their objectives in the Doha Round without a significant change in their protectionist farm policies. Third, the Asian financial crisis of 1997–98 demonstrated the economic linkages between the countries in the region, as well as each country's vulnerability to economic problems that beset its neighbors.

In addition, the past decade or so has seen the launch of new negotiations toward what I have called "superregional" pacts—pacts that seek to integrate already existing trading blocs. The most notable examples of these initiatives are the ongoing negotiations on a Free Trade Area of the Americas (FTAA), the EU-Mercosur FTA, and the long-term effort to achieve free trade and investment in the Asia-Pacific region.

Perhaps the biggest change over the past two decades, however, has been the global economic environment in which FTAs and other regional pacts operate. Globalization of economic activity has encouraged new alliances between developed and developing countries, sharpened the competition for foreign investment, and placed a high premium on outward-oriented policies. Concerns about insular trading blocs do not square with the market imperatives of the new global economy. Market forces now discipline discriminatory trade practices far more quickly and effectively than in the past; and government policies that raise the cost of doing business by imposing excessive trade, tax, or regulatory burdens often find their companies retrenching and investors relocating elsewhere.

Table 1.1 reports the FTAs and customs unions that are in effect or under negotiation as of May 2003. It includes those that have been notified to the WTO, those concluded but not notified to the WTO, and those under negotiation, as best can be discerned from public and private sources.⁴ The totals underestimate the number of active regional negotiations; many

4. I appreciate the help provided by Clemens Boonekamp and Carmen Pont-Vieira of the WTO Secretariat in compiling information on regional pacts from published and unpublished sources for this table.

Table 1.1 Regional trade agreements in effect or under negotiation (as of May 2003)

Country/region	Notified to WTO ^a	Concluded but not notified	Under negotiation ^b	Total	Share (percent)
Agreements involving	155	83	46	284	100
United States	3	2	6	11	4
Canada	4	0	5	9	3
European Union or EFTA	59	6	6	71	25
Japan	1	0	1	2	1
Intra-FSU/CIT	41	48	6	95	33
Intradeveloping countries	27	26	23	76	27

EFTA = European Free Trade Association

FSU/CIT = former Soviet Union and other countries in transition

a. Agreements are counted only once, even if they are notified to the WTO under both GATT Article XXIV and GATS Article V. However, the North American Free Trade Agreement is counted twice, as US-NAFTA and Canada-NAFTA.

b. Current negotiations on a Free Trade Area of the Americas are counted twice as US developing countries and Canada developing countries; similarly, the Canada-EFTA FTA is counted under Canada and under EFTA.

Sources: WTO Web site, Trade Topics, www.wto.org/english/tratop_e/region_e/region_e.htm, and unpublished data sheets from the

new initiatives were launched in the second half of 2003, particularly in East Asia and Latin America, and several more have been vetted since the collapse of the WTO ministerial in Cancún in September 2003. Overall, these new initiatives reinforce the general trends reflected in the table and discussed below. The numbers differ somewhat from those reported by the WTO; I have corrected for double counting of regional pacts and for a few other classificatory abnormalities in the WTO data to provide a better breakout on who is doing business with whom.⁵

The table confirms that regional pacts have proliferated; almost all WTO members participate in one or more of the nearly 300 agreements in effect or under negotiation (WTO 2003). When these are taken together, one can understand why concerns arise that discriminatory trade preferences created by these pacts could threaten to fragment the multilateral trading system and to undermine its core principle of MFN treatment. Care should be taken, however, in drawing general conclusions from this seemingly vast pool of agreements.

First, the table groups together regional pacts that differ widely in terms of content and participants.⁶ Some, such as the Closer Economic

5. For example, the WTO database double counts agreements containing goods and services that have been notified under both the GATT and GATS.

6. Seventy-seven percent of the regional pacts in force “are intended to be” FTAs or customs unions; 27 of these pacts cover goods and services. The other 23 percent are “partial scope agreements” (WTO Secretariat 2003).

Relations trade agreement between Australia and New Zealand, or the North American and Chile-US FTAs, are comprehensive FTAs. Others simply reduce or eliminate tariffs, subject to extensive sectoral or product exceptions; such pacts are the rule among developing countries. Some are notable for the volume of trade eligible for preferences; others apply to very little trade. Their trade impacts and implications for the world trading system vary accordingly. So beware comparing acorns and oak trees!

Second, many of the agreements that have been recorded so far have been neighborhood affairs. About one-quarter of the total agreements involve European countries; most of these pacts contributed to the incremental development of the European Union and the European Free Trade Association. Another one-third of the agreements are among countries that formerly were part of the Soviet Union and other countries in transition. These pacts sought to reestablish trade ties that formerly existed in the socialist bloc among countries that are now returning to a market-oriented trading system. In addition, a little more than one-quarter of the total are agreements among developing countries, seeking to link together their small fragmented markets into an integrated regional economy. Together, these neighborhood deals account for 85 percent of all regional pacts covered in table 1.1.

Third, new negotiations represent about 16 percent of the agreements listed in table 1.1, and this sum does not include negotiations launched since mid-2003 by the United States, Japan, India, Thailand, and others. Conservatively, I estimate that there are more than 60 FTAs under negotiation as of January 2004. FTA negotiations have accelerated in response to and in tandem with the drift in WTO talks since the failed Cancún ministerial in September 2003.

Fourth, the United States has to date been a very small part of the story, accounting for only 4 percent of the total agreements. While the US share of FTAs under negotiation is significantly higher, it still represents less than 20 percent of new FTA talks around the globe. Almost all of the new US initiatives involve developing countries and require agreement on a comprehensive agenda of market access reforms in goods, services, and agriculture (though liberalization of some farm products is subject to lengthy transition periods or outright exemptions). If all these initiatives culminate in FTAs, they will cover more than 40 percent of US merchandise trade (see chapter 13 of this volume).

While table 1.1 describes general trends over four decades, what is perhaps more interesting and more important for the trading system is the recent activity by developing countries—both among themselves and in partnership with developed countries. The totality of these initiatives is reported in table 1.2 (again as of May 2003).

Table 1.2 reports the regional pacts in which developing countries participate. The totals illustrate the active and growing role of regionalism in the developing world. Agreements involving developing countries repre-

Table 1.2 Developing-country participation in regional trade agreements (as of May 2003)

Country/region	Notified to WTO	Concluded but not notified	Under negotiation	Total	Share (percent)
Developing-country agreements					
<i>involving</i>	76	34	39	149	100
United States	3	2	4	9	6
Canada	4	0	3	7	5
European Union or EFTA	24	5	5	34	23
Japan	1	0	1	2	1
Intra-FSU/CIT	16	0	0	16	11
Intradeveloping countries	27	26	23	76	51

EFTA = European Free Trade Association

FSU/CIT = former Soviet Union and other countries in transition

Sources: WTO Web site, Trade Topics, www.wto.org/english/tratop_e/region_e/region_e.htm, and unpublished data sheets from the WTO.

sent more than one-half of all FTAs and customs unions (recorded in table 1.1); more than half of these are pacts among developing countries, as noted above, and about one-quarter link developing countries with European countries.

Table 1.2 also highlights the increasing participation of developing countries in new regional trade negotiations. Almost 85 percent of the agreements that are currently under negotiation worldwide involve developing countries, and more than half of these are between developing countries. Whatever one thinks about the systemic implications of this spurt of negotiating activity, the proliferating regionalism among developing countries clearly has very important consequences for development.⁷

Why are developing countries so interested in FTAs? In the past, these countries were able to obtain improved access to industrial markets through GATT negotiations that did not require them to reciprocate by opening their own markets to foreign competition. While useful, prior GATT rounds had two major shortcomings: they did not prompt policy changes in developing countries that would induce adequate flows of investment and transfers of technology (apart from extractive industries), and competitive agricultural and manufactured exports of developing countries often were excluded from the reforms. In short, developing countries were free riders on the GATT system until the Uruguay Round, but derived only modest benefits from their minimal contributions to GATT negotiations. They protected their own markets, but in turn had to accept the maintenance of high foreign trade barriers against their most competitive exports.

7. For a comprehensive analysis of this set of issues, see Schiff and Winters (2003).

Though such policies never yielded big economic rewards, they were politically convenient. Many developing countries relied on protected home markets and commodity exports to support modest growth; some followed a strategy of export-led growth and became platforms for the assembly and export of light manufactures. Their success in turn provoked a wave of new protectionism in developed markets via so-called voluntary export restraints, antidumping and countervailing duties, and special protection regimes like the Multi-Fiber Arrangement. This strategy of limited engagement in the world trading system became increasingly untenable over the past two decades with the globalization of economy activity, which has been punctuated by a series of financial crises, depressed commodity prices, and growing competition from China.

Countries must now adapt quickly to changing conditions in world markets or fall sharply behind in the global competition for market share and investment resources. They can no longer afford to protect their industries from foreign competitors; the world will simply pass them by. Trade and integration arrangements must be part of each country's policy response and integrally linked with its development strategy (though not necessarily the main driver of that strategy).

For developing countries, regional trading arrangements have become increasingly important components of economic policy for several reasons. First, they contribute to economic growth by spurring competition in domestic markets, dampening inflation, and promoting investment.⁸ Second, they provide an "insurance policy" against new protectionism at home and abroad by substantially raising the cost of reversing the free trade reforms mandated by the regional pacts—and thus creating a more stable and attractive environment for investment. Indeed, competition for investment drives many of the FTAs in which developing countries participate. If the country maintains high levels of protection, costly regulations, or discriminatory standards, investors generally will opt to locate in other countries that have policies more conducive to production and investment.

That said, trade pacts are not magic potions that automatically create economic prosperity (even if they are often sold to the public on that promise). Countries can take full advantage of the new trading opportunities created by trade accords only if they pursue domestic economic policies—in conjunction with their trade reforms—that provide a stable macroeconomic climate for investment and job creation, and that command sufficient political support to ensure their durability. Thus, one of the most important aspects of FTAs is that they encourage developing countries to liberalize their own trade and regulatory barriers in order to

8. Much of the benefit derives from the removal of restrictions to economic activity in their own markets, but countries also gain by being able to trade and invest across a broader regional market.

attract foreign investment. Developing countries face tough competition for investment and therefore have to engage in a process of competitive liberalization to secure the capital inflows needed to finance their development as well as to import needed technologies and management skills. Competitive liberalization is what differentiates current integration policies from past episodes among developing countries where import-substitution policies supported defensive fortress strategies that did not seek to improve the efficiency and competitiveness of their economies in contending with the outside world.

FTAs: Balancing Benefits and Costs

Lowering intraregional trade barriers expands trade among partner countries and encourages economies of scale of production together with intra- and interindustry specialization. But do FTAs generate *net* trade creation? and *net* welfare gains for both the FTA members and their third-country partners? If the FTA preferences shift imports from suppliers in third countries to less efficient regional firms (i.e., trade diversion), then the pact may increase costs and reduce welfare. A lot depends on the impact on productivity in the partner economies, as well as on the conditions applied to qualify for the trade preferences (e.g., rules of origin) that may increase transaction costs and reduce economic benefits.⁹ Thus, determining whether FTAs help or hinder the multilateral trading system requires a complex calculus.

On the positive side, FTA advocates cite four main advantages of pursuing regional pacts in tandem with multilateral reforms: advancing trade liberalization, establishing useful precedents for WTO talks, locking in domestic reforms, and bolstering alliances among trading partners. On the negative side, critics of FTAs generally cite four sets of problems created by the negotiation and implementation of regional trade agreements: trade and investment diversion (which may also create disincentives to advance WTO talks), overlapping and conflicting trading rules and regulations, attention and resource diversion from WTO talks, and bad precedents for other trade accords. The following subsections summarize the main points on each side.

Benefits of Pursuing FTAs

The first and most important benefit of FTAs is the depth of trade reform to which the partner countries aspire. If they are true to their name, FTAs seek to eliminate barriers on “substantially all” trade between the partner

9. For a fuller discussion of these issues, see Wonnacott and Lutz (1989).

countries (some are obviously less perfect in this regard than others). In contrast, WTO negotiators pursue incremental reforms in each trade round, leaving substantial barriers in place after the accords are fully implemented. The difference can be put simply: deeper cuts, but by fewer countries, and applied on a discriminatory basis. FTAs achieve deeper cuts in trade protection than WTO reforms but the FTA liberalization is accorded to only a few countries, while multilateral agreements are applied on an MFN basis to the entire WTO membership.

Advocates of FTAs argue that, on balance, the pacts are trade creating and spur positive welfare gains for participating countries as well as, over time, for third countries by stimulating growth in the FTA region. They also subscribe to the “bicycle theory” of trade negotiations, citing the systemic benefits of maintaining momentum on trade reform. Indeed, they argue that for the past four decades, GATT and WTO negotiations have been spurred by the desire to offset discrimination generated by regional pacts. Ongoing multilateral liberalization, in turn, reduces the value of regional preferences (or the amount of discrimination against third-country suppliers to the FTA region). As long as countries proceed with WTO reforms in tandem with their FTA initiatives, regional preferences will have a short “half-life” and FTA partners will lack incentives to build regional fortresses designed to shield their economies from foreign competition. Consequently, regional industries will be more likely to use the temporary period in which FTA preferences accord protection to restructure their operations so that they can compete effectively against foreign suppliers rather than lobby for continued protection.

In general, FTAs are easier to conclude than WTO accords because they require agreement among a small number of “like-minded” countries rather than among the larger and more diverse WTO membership.¹⁰ To be sure, this ease is partly due to the limited applicability of FTA liberalization. Since the FTA reforms apply only to member countries, competition remains partially constrained; thus FTAs are easier to sell to domestic lobbies but bring fewer welfare benefits for the economy as a whole.

Second, FTAs often include rights and obligations regarding domestic regulatory practices and other “behind-the-border” measures that affect trade and investment flows—issues that had not until recently been the primary focus of multilateral talks. In several instances, FTA provisions have established precedents for broader multilateral accords in areas such as services and electronic commerce.¹¹ In these areas, discriminatory application of FTA rules is possible but less problematic. Usually the de-

10. Bhagwati (1993) disagrees, but his analysis doesn’t compare the new North-South agreements against the more complex WTO process.

11. The US-Canada FTA provided very useful precedents on services that were translated into the GATS in the Uruguay Round. The US-Chile FTA may similarly affect the area of e-commerce.

12 FREE TRADE AGREEMENTS

mands of the marketplace (not to mention the inordinate administrative costs of implementing different standards and requirements for different countries) require convergence toward a common set of standards applied to all trade.

In addition to the value of FTAs in setting precedents, there are also important learning-by-doing effects from engaging in the negotiating process. Sitting at the negotiating table provides an education that can't be replicated in any university: officials learn to negotiate by negotiating.¹² This aspect is especially important for developing countries; FTA negotiations are helping them to educate a new class of trade negotiators to represent them in regional and WTO talks. Similarly, learning-by-doing benefits derive from the process of problem solving in new areas on the trade agenda: inevitably, the complexities of trade problems are not fully exposed until one tries to negotiate a solution.

Third, FTAs have an important lock-in effect on domestic reform: policy reversals become more costly because changes that violate the free trade obligations could trigger retaliation by trading partners. FTAs thus help governments to withstand the protectionist demands of their domestic lobbies and deflect pressure to take actions that are politically alluring but economically undesirable; in so doing, they reduce uncertainty about trade and regulatory policies and thereby facilitate business planning and investment. For many developing countries, this benefit is key to the success of their investment-led development strategies.

Fourth, FTAs strengthen trade relations among partner countries and make it easier to build alliances for WTO reforms in areas of common interest. The Doha Round itself probably would not have been launched if FTA partners (current and prospective) of the United States and the European Union had not worked in unison to craft a balanced agenda for the talks.

FTA Drawbacks

Part of the perceived advantage of an FTA is receiving preferential tariff treatment in the partner country. The higher the MFN tariff, the larger the margin of preference for suppliers based in the FTA partner countries and therefore the greater the advantage. However, the explicit discrimination also generates the key drawback of FTAs: trade and investment diversion.

Critics of FTAs decry the negative impact of regional pacts on global economic welfare as trade and investment are diverted to take advantage of the preferential trading regime, and the distraction—or even

12. For this reason, South Korea first entered into FTA negotiations with Chile and New Zealand to upgrade the negotiating skills of its trade officials before embarking on talks with Japan and other major trading partners.

disengagement—from multilateral trade negotiations. Richard Baldwin (1993) notes that trade diversion increases the cost of nonparticipation for third countries and spurs those that suffer trade diversion to attempt either to join the FTA or to form their own bloc. The key question is whether this “domino regionalism” fragments the trading system into protectionist blocs or spurs competitive liberalization that reinforces multilateral reforms (Bergsten 1996).

In North-South FTAs, trade diversion is often generated in sectors where MFN trade barriers are high, such as textiles, clothing, and agriculture—which also happen to be sectors of widespread export interest for developing countries. FTAs thus provide a temporary fillip to export-led growth for developing-country participants, though their gains usually come at the expense of other developing countries that are penalized by the discrimination. NAFTA caused substantial trade and investment diversion in the textile and clothing sectors from the Caribbean Basin countries as a result of the preferential treatment accorded Mexican industry. The US African Growth and Opportunity Act (AGOA) now seems to be having a similar adverse effect on nonbeneficiaries in Africa and elsewhere.

The extent of the problem caused by trade and investment diversion depends importantly on whether there is new multilateral liberalization and whether FTA partners extend similar preferences to other countries (as the United States has done with the Caribbean Basin Initiative and the Andean Trade Preferences Act, for example). Both programs dilute the value of the trade preferences of the old and new FTA partners. Unfortunately, some FTA beneficiaries try to preempt the “erosion” of their margins of preference by dragging their feet on WTO reforms (including the phaseout of the Multi-Fiber Arrangement due in January 2005).

How serious is the concern that FTAs spawn WTO foot-draggers? Some FTA critics argue that if a country cuts a trade deal with its key trading partners, it will have less interest in MFN reforms in the WTO. The classic case cited is the Common Agricultural Policy (CAP) of the European Community—the so-called glue of European integration—which arguably has made the Europeans less interested in GATT/WTO farm trade reforms (even though those policies induced the United States and others to enter into new GATT rounds in the 1960s and 1970s to try to reduce the subsidies provided and barriers erected by the CAP). FTA critics argue that European integration has made it harder to reform agriculture and that the task will become even more difficult with the expansion of the European Union in May 2004. However, European agriculture seems to be a special case that has not been replicated elsewhere to the extent of affecting GATT negotiations.

But does this hold true for North-South agreements? Some have claimed that Mexico is less interested in the FTAA because of NAFTA and doesn't want other Latin American countries to share its free access to the US

market, but the facts do not seem to bear this argument out. Mexico has embarked aggressively on FTA negotiations with trading partners around the globe in parallel with its participation in the FTAA negotiations, precisely because it knows that the United States has added and will continue to add more partners, thus diluting the value of its preferences in the US market. Rather, Mexico is using its growing network of FTAs to position itself as an attractive platform for foreign direct investment to serve burgeoning Mexican and hemispheric markets. The successful conclusion of the FTAA reinforces that strategy.

To be sure, some developing countries still want to block MFN reforms to maintain their margins of preference in industrial markets; a large bloc of them voiced this position in Cancún in September 2003. Even if they succeed in blocking the WTO process, however, their protectionist efforts will fail because they cannot prevent the major industrial countries from granting unilateral trade preferences or concluding new FTAs that will diminish the value of their preferences in those markets. The policy lesson is clear: FTAs give developing countries a brief head start on competing for investment and export markets. Those that meld the trade preferences with domestic reforms can reap long-term benefits. Those that don't will find their trade gains transitory and the investment footloose.

The second major problem with FTAs is that they can create overlapping sets of trade rules and regulations that make sourcing products to different markets complicated and often more costly. Bhagwati has artfully called this *mélange* of different rules, procedures, and standards generated by different FTAs a "spaghetti bowl" of trade regulations.¹³ FTA critics have specifically decried the imposition of restrictive rules of origin, which can be particularly distorting and can increase transaction costs.¹⁴ Origin rules are blatant tools of discrimination, but their impact on business in terms of lost sales or increased transactions costs is unclear. Problems flourish in highly protected sectors; if MFN trade barriers are low, the protectionist effects of origin rules diminish, since importers can simply ignore the regional rules and pay the MFN tariff (as often occurs in US-Canada trade).¹⁵ More empirical research is needed to determine how big a problem the spaghetti bowl really is.

Third, countries have limited resources to engage in trade negotiations, and FTAs clearly dilute the effort that can be directed toward WTO

13. See Bhagwati and Panagariya (1996) for a discussion of this problem.

14. Other nontariff barriers such as technical standards and phytosanitary measures also enter into this equation.

15. Because developing countries need to meet the standards of the dominant economy in the regional bloc to take advantage of the new trading opportunities, concerns about different standards may be overstated. More difficult is the problem of competing standards set forth by the United States and the European Union, which can be best addressed in multi-lateral negotiations.

initiatives. This resource scarcity problem is particularly constraining for developing countries that have only a few officials to run domestic agencies and participate in bilateral, regional, and WTO talks. But it also affects US negotiators, whose budget is inadequate to meet the extensive demands set out in US Trade Promotion Authority by their congressional masters (see Ambassador Robert Zoellick's letter appended to GAO 2004).

Fourth, regional pacts can yield both good and bad precedents (involving both rules and exceptions to trade reforms). FTA critics charge that North-South agreements are more prone to the latter owing to the asymmetric economic and political influence of the larger, industrialized countries. Here again, the prime example is the rules of origin in US FTAs, especially those regulating trade in textiles and clothing. Some critics also claim that FTAs establish bad precedents by including trade obligations in areas such as intellectual property, labor, and the environment—issues that they believe should be handled apart from trade pacts. Of course, other groups argue forcefully that these provisions are good precedents and should be incorporated into or elaborated in multilateral trading rules. In addition, some FTAs carve out important sectors like agriculture from the free trade regime, or exempt key products from the reforms (e.g., the US-Australia FTA, which excludes sugar).

In sum, FTAs can be trade creating or diverting, can build support for or divert attention from multilateral trade negotiations, can enhance or dilute (or both) negotiating resources, and can foster good and bad precedents for other trade initiatives. In addition, FTAs often can reinforce and augment domestic economic reforms in developing countries. The outcome depends on how the pacts are crafted, the commitment of the partner countries to the WTO system, and how much progress is made in parallel WTO talks.

FTA critics disagree; they remain steadfast in their commitment to the GATT/WTO process, where reforms have to be implemented (with a few exceptions) on a most favored nation basis. If WTO talks face tough sledding, their counsel is to redouble efforts at MFN reforms rather than to create new distortions via competing preferential regimes. This preference for multilateralism rings true with economic theory and arguably with the conduct of international trade negotiations throughout the GATT era. But does it fit the world of the WTO and the current Doha Round?

The new WTO does not work like the old GATT, for better or for worse, and its negotiating dynamics are much more complicated. First, conducting and concluding accords are much more complex than in prior GATT rounds. The WTO has 146 member countries; membership could increase to 170 by the end of this decade if many of the current applicants complete their accession negotiations. Most of the members are developing countries; unlike during the GATT era, many of them now have an important stake in international trade and therefore an important stake in getting something

out of the trade agreements. Because each country needs to be able to bring home a trophy to justify the concessions that they make to their trading partners, WTO talks have to produce a big package of agreements that accommodates the diverse interests of its large membership. Since the WTO still operates by consensus, the task of crafting a set of agreements that meets the demands of the large and increasingly disparate membership has become much more difficult (as evidenced in Cancún).¹⁶ WTO deliberations are now the subject of intense coalitional politics unknown in the GATT era, when the United States and European Community were the main hegemony. Members now need to build alliances by issue (the Cairns Group on agriculture) or region (the Caribbean Regional Negotiating Machinery) or groups of developing countries (the G-20 that formed before Cancún); the alliance building that takes place when one negotiates an FTA can be very helpful in pursuing common objectives in WTO talks.

The second major problem is that the United States and the European Union have very little left to offer at the negotiating table in terms of market access, except what is very difficult to give—that is, the protection in agriculture and textiles that has survived eight previous rounds of multilateral trade negotiations and that is of major export interest to developing countries. In turn, developing countries seem reluctant to lower their own generally much higher trade barriers without increased and more secure access to industrial markets. To get the United States, Europe, and Japan to commit to significant reforms in long-standing protection in agriculture and in some manufacturing sectors, other WTO members—including middle-income developing countries—need to offer concrete reductions in their protection as well. In short, the WTO talks need to produce a big deal or they may not achieve any agreement at all (see Schott 2003). That is why working out a deal in the WTO is much more complicated and why FTAs can reinforce the negotiating dynamics required for a successful WTO round.

Strengthening WTO Rules on Regional Trade Pacts

The political economy of trade liberalization and the increasing complexities of negotiating in the WTO seem to require an admixture of bilateral, regional, and multilateral trade initiatives. The following chapters in this volume will test this argument for both extant and prospective agreements between the United States and its trading partners in Latin America, Asia, and Africa and the Middle East. But if it is true, there is nonetheless a need to strengthen WTO rules to better ensure that FTAs promote

16. The consensus rule is still preferable to a voting scheme, but reform of the WTO's consensus-building process could make WTO decision making more efficacious and equitable (see Schott and Watal 2000).

regional deals that complement the objectives and initiatives of the multilateral trading system. There is no lack of analysis or proposals on how to redress the weaknesses of WTO obligations on regional trading arrangements (Bhagwati 1993; WTO Secretariat 1995; Lawrence 1996; Winters 1998; Schiff and Winters 2003). The following are some basic reforms that could be included in the Doha Round talks.

First, WTO members should revisit the vague and incomplete disciplines of GATT Article XXIV and GATS Article V. This task is already part of the mandate of the Doha Round, though scant progress has been made in “clarifying and improving disciplines and procedures under the existing WTO provisions” or taking account of “the developmental aspects of regional trade agreements.”¹⁷ Many proposals focus on setting some numerical definition for the GATT’s “substantially all” test. While logical, such targets raise more definitional problems than they solve. In contrast, it is feasible and useful to develop indicative guidelines for rules of origin. Less is better when it comes to origin rules—the more complex and industry-specific the requirements, the more likely the rules will have a chilling effect on trade.

Second, FTA partners should commit to harmonize and lower their MFN tariffs over a 10-year period, so that there is a complementarity in the regional and multilateral reform efforts. This requirement would also mitigate problems with restrictive rules of origin by reducing the wedge between MFN and preferential tariff rates. And of course it would ensure the advance of WTO reforms, so that progress continues to be made on the path toward global free trade.

Third, the WTO should undertake more active surveillance after pacts enter into force. Most of the time, when it does take place, WTO monitoring of regional pacts examines only what was negotiated and whether it comports with GATT and GATS obligations. However, what is really important is how the agreements are implemented and what effects they have on international trade and investment. That requires *ex post* analysis, which should be done both by the WTO Secretariat in the trade policy reviews and by independent groups of experts. Assessments of the economic impact of FTAs and customs unions with intraregional trade exceeding \$10 billion annually should be conducted every five years, starting five years after the entry into force of the agreement.

In sum, FTAs are most beneficial if their coverage is comprehensive, if origin rules are kept to a minimum, and if the members are committed to work together to advance MFN trade reforms in the WTO. For developing countries in particular, the FTA strategy works best under the umbrella of a strong rules-based multilateral trading system. New WTO rules

17. See paragraph 29 of the Doha Ministerial Declaration, adopted November 14, 2001, WT/MIN(01)/DEC/W/1; www.wto.org/english/thewto_e/minist_e/min01_e/mindecl_e.htm.

should be crafted to limit the downside risk of FTAs for the multilateral system as part of renewed efforts to move the Doha Round toward a successful result. The greatest risk to the WTO system is the potential failure of the Doha Round. In that event, problems with existing WTO rules would not be fixed and festering trade disputes would erode confidence and support for the multilateral trading system. Properly managed, regional pacts can be an important part of the success of, rather than a third-best substitute for, the WTO system.

References

- Baldwin, Richard. 1993. *A Domino Theory of Regionalism*. NBER Working Paper 4465. Cambridge, MA: National Bureau of Economic Research.
- Bergsten, C. Fred. 1996. *Competitive Liberalization and Global Free Trade: A Vision for the Early 21st Century*. APEC Working Paper No. 96-15. Washington: Institute for International Economics. Available at www.iie.com/publications/wp/1996/96-15.htm.
- Bhagwati, Jagdish. 1993. Regionalism and Multilateralism: An Overview. In *New Dimensions in Regional Integration*, ed. Jaime de Melo and Arvind Panagariya. Cambridge: Cambridge University Press.
- Bhagwati, Jagdish, and Arvind Panagariya, eds. 1996. *The Economics of Preferential Trade Agreements*. Washington: AEI Press.
- Frankel, Jeffrey. 1997. *Regional Trading Blocs in the World Economic System*. Washington: Institute for International Economics.
- General Accounting Office, United States (GAO). 2004. International Trade: Intensifying Free Trade Negotiating Agenda Calls for Better Allocation of Staff and Resources. GAO-04-233. Report to Congressional Requesters. www.gao.gov/new.items/d04233.pdf (January).
- General Agreement on Tariffs and Trade (GATT). 1994. *Guide to GATT Law and Practice: Analytical Index*. Geneva: General Agreement on Tariffs and Trade.
- Lawrence, Robert Z. 1996. *Regionalism, Multilateralism, and Deeper Integration*. Washington: Brookings Institution.
- Schiff, Maurice, and L. Alan Winters. 2003. *Regional Integration and Development*. Washington: World Bank and Oxford University Press.
- Schott, Jeffrey J. 2003. Unlocking the Benefits of World Trade. *The Economist*, November 1, 65–67. Available at www.iie.com/publications/papers/schott1103.htm.
- Schott, Jeffrey J., and Jayashree Watal. 2000. Decision-making in the WTO. In *The WTO after Seattle*, ed. Jeffrey J. Schott. Washington: Institute for International Economics.
- Viner, Jacob. 1950. *The Customs Union Issue*. New York: Carnegie Endowment for International Peace.
- Winters, L. Alan. 1998. Regionalism and the Next Round. In *Launching New Global Trade Talks: An Action Agenda*, ed. Jeffrey J. Schott. Washington: Institute for International Economics.
- Wonnacott, Paul, and Mark Lutz. 1989. Is There a Case for Free Trade Areas? In *Free Trade Areas and U.S. Trade Policy*, ed. Jeffrey J. Schott. Washington: Institute for International Economics.
- WTO Secretariat. 1995. *Regionalism and the World Trading System*. Geneva: World Trade Organization.
- WTO Secretariat. 2003. The Changing Landscape of RTAs. Paper prepared for the Seminar on Regional Trade Agreements and the WTO, Geneva, November 14. Available at www.wto.org/english/tratop_e/sem_nov3_e/boonekamp_paper_e.doc.

Comment

RICHARD N. COOPER

I am extremely doubtful that free trade agreements make a positive contribution to overall human well-being, which is what we ought to keep our eyes on.

I want to make four substantive points and then conclude with two qualifications. The first substantive point is that one should never forget that when country A—the United States, for example—discriminates in favor of a trading partner, it discriminates *against* other trading partners. FTAs are seen as favorable agreements because the United States eliminates duties on goods from Chile or Singapore or whomever, but whenever it does that, it discriminates against everyone else. For a country that has global trade interests and pretensions of having global political interests and influence, this seems to me a thoroughly undesirable and unwise course to take. The United States thereby makes selected friends but also leaves a bad taste with other countries, which outnumber those friends by a large margin. I have nothing against Chile, but why should the United States discriminate in favor of goods from Chile as opposed to those coming, for example, from the Philippines or Thailand or India? It seems to me that US policymakers have not persuasively answered that question. Discrimination means discrimination *against* as well as discrimination *for*, and on balance such discrimination is bad politics. That is something to keep foremost in mind. Indeed, most favored nation treatment guided US trade policy for decades for just that reason.

Richard N. Cooper is Maurits C. Boas Professor of Economics at Harvard University and chairman of the Advisory Committee of the Institute for International Economics.

My second point is that unless negotiators are very careful, FTAs are also bad economics. The possibilities for trade diversion are well known. These days economists properly also worry about investment diversion because foreign direct investment, in particular, has become an important part of trading arrangements. Indeed, from the Canadian point of view investment diversion was the main point of the US-Canada Auto Pact of the mid-1960s, and the United States acquiesced in it.

Article XXIV of the General Agreement on Tariffs and Trade (GATT) provides some rules on the question of trade diversion, subsequently incorporated into the World Trade Organization (WTO). These rules were designed to minimize (but not eliminate) trade diversion by requiring that a permissible free trade area eliminate all duties and other restrictive barriers, except those that are permitted elsewhere in the GATT, “on substantially all trade between the constituent territories.” The original European Community, which was a customs union, met this standard, as did the North American Free Trade Agreement (NAFTA), but most free trade areas do not. If one relaxes this Article XXIV standard that substantially all trade has to be covered, what is the likely outcome? The likely outcome, I submit, is that the exclusions in practice will take place precisely in those sectors where trade creation is likely to be most substantial. In other words, the more one backs away from the comprehensive requirement, the more likely the agreement is to involve trade diversion, so that most FTAs have a bias toward trade diversion.

The GATT also required that a free trade area have the approval of the contracting parties before it is put in place. Contracting parties were obliged to promptly notify the GATT of any FTA, specifying all of its characteristics. Then the GATT was supposed to set up panels to scrutinize the nature of the agreement to see if it was consistent with Article XXIV. If my information is correct, up until 1995—that is to say, up until the transformation into the WTO—69 cases were actually notified to the GATT. Only 6 of them actually got GATT approval; the other 63 effectively disappeared. There were no findings. They were neither approved nor formally disapproved; they were just in limbo as far as the GATT was concerned. Recall that one of the characteristics of the GATT was that a panel finding had to have unanimity, including the agreement of the parties involved. So far as I am aware, performance on this score has been no better since 1996. In my view, Article XXIV was well conceived but not well executed. There was of course the possibility, as there typically is in international agreements, for a waiver by a two-thirds vote—and the first new postwar discriminatory bloc, the European Coal and Steel Community (which certainly did not cover substantially all trade), got a GATT waiver. The issue was put, it was discussed, it was decided on balance to be a good thing. The US-Canada Auto Agreement also got a waiver, more dubiously. Most FTAs do not have waivers.

So requirements of the GATT have been all but ignored. Developing countries—most of the free trade areas are among developing countries—just used the blanket excuse that “special and differential treatment” essentially absolved them of all serious responsibility under the GATT, and the developed countries let them get away with that. I do not know what excuse Europeans used for all of their bilateral, partial-coverage free trade areas; they engaged extensively in this process. I refer here to the arrangements between the European Community and Algeria, Morocco, Israel, and other nonmember countries, not to the European Community itself. This process goes way back, but no country seriously challenged them on it. The new US free trade areas presumably meet the comprehensive standard, although the FTA with Israel, which was the first of these bilateral US agreements, falls short, at least as regards agriculture and some services.

My third point is that free trade areas, in an important difference from customs unions, require rules of origin, especially if the tariff rates differ significantly among the parties. Yet the need for rules of origin creates a playground for protectionist interests. That is the only way to describe it. Why? Because rules of origin are arcane and technical. Outsiders, such as academics or journalists, have a hard time paying serious attention to them, and even the negotiators quickly lose interest. The Polish-EU Agreement has rules of origin running to 81 pages of fine print. The rules of origin governing NAFTA cover 200 pages. You can be sure that the folks that are most intensely interested have scrutinized every line, indeed have written many lines, and they come to dominate the process. So the rules of origin often turn out to be highly protectionist. Examples in NAFTA, which is a comprehensive agreement, concern textiles and apparel, autos, processed foods, TV picture tubes, and a host of other items. A widely quoted example of trade diversion involves tomato paste from Chile, which was a major provider to Mexico before NAFTA; that paste is now provided from within NAFTA. The need for rules of origin, effectively dominated by the special interests, increases trade diversion relative to trade creation.

My fourth point concerns a claim made in support of FTAs. Jeffrey Schott argues in his overview chapter, as have others, that FTAs often lead to more general trade liberalization. I think that claim is highly dubious. It has not been put to a serious test because the great proliferation of these agreements has taken place only in the past decade, and the Doha Round is still at an early stage. There are, however, a number of examples where beneficiaries of preferential trade agreements with the European Community resisted trade liberalization in the Uruguay Round because it would reduce their margins of preference. That may have been a rational position from their perspective, particularly if they were beneficiaries of trade diversion, and it may be expected in the future also to create resis-

tance to multilateral trade liberalization. So the claim that FTAs lead to more trade liberalization is highly dubious, but it still remains to be tested seriously.

Now let me make two qualifications to my four objections to FTAs. The first concerns NAFTA: I was and remain a strong supporter of NAFTA. It was comprehensive in coverage; it went way beyond the substantive agenda of the Uruguay Round, especially in agriculture and services. It thus encompassed a scope that was not seriously on the multilateral agenda at that time. Moreover, the Uruguay Round had hit a serious snag in 1990, and it is arguable that NAFTA did, contrary to my fourth point above, move the Uruguay Round forward, particularly in nudging the Europeans. But most important, the United States had a well-understood and easily explained strategic rationale for having a free trade area with Mexico, centering on a variety of issues, not least crime and migration. Mexico proposed an FTA to commit President Salinas de Gortari's successors to his liberal reforms, and the United States responded positively. America's strategic interest in a stable and prosperous Mexico is strong and evident. The United States has a general interest in stable and prosperous countries all around the world, but there was a special, clearly explicable case that could be made with respect to Mexico. The rest of the world could easily understand that. That case cannot be made with respect to Chile, Mercosur (the Southern Cone Common Market), Singapore, or indeed any of the other countries, except arguably those in Central America, that are now under US consideration for free trade areas. So in my mind, NAFTA stands out as a legitimate exception to the generalizations that I have made.

My final qualification concerns my presumption that negotiators can successfully move ahead in the multilateral framework, which has served the world economy extremely well during the past half century. The United States ought to devote its negotiating and political energies to getting a successful conclusion to the multilateral negotiations, currently the Doha Round and some unfinished business from the Uruguay Round. However, a serious multilateral negotiation might fail for a variety of reasons—perhaps Europe will not liberalize agriculture or India cannot agree to any further liberalization, even though India retains one of the world's highest levels of protection (there is vigorous domestic debate over the limited liberalization that India has already undertaken). Given the consensus process, it only takes one significant player to bring the whole negotiation to a halt. Should the multilateral process fail, then coalitions of the willing under those circumstances become much more attractive. FTAs are a fallback position. But my view is that they ought to be seen as just that, as fallback positions for failed multilateral negotiation, and not as the main thrust, which is what they seem to have become for the United States, emulating Europe. Now the Asian countries are in dis-

cussion about moving down the same path. As Herminio Blanco said during the conference, this is a virus and everyone has caught it. It needs to be contained.

Governments are not good at admitting that they have made mistakes. In the United States, this is a bipartisan mistake. It has occurred under several presidents, starting with Ronald Reagan. Somebody ought to say: “Well, we have looked at the matter again. We are going to put our energies in the coming years into maintenance and furtherance of the multilateral system. We will postpone further free trade areas.” The United States should not be putting serious effort into negotiating FTAs at the present time.

Comment

RENATO RUGGIERO

There is a paradox in international trade policy today. Globalization is the word on everyone's lips, yet regional agreements have never been so popular. One hundred fifty-five regional trade agreements are in force around the world, half of them concluded since 1990; 83 are concluded but not notified to the World Trade Organization; and 46 are in the making. Every WTO member is part of at least one of them. Almost half of world trade now occurs between countries belonging to them. This headlong rush toward regionalism has gained new momentum in recent years. For a start, the European Union, whose long-standing commitment to regional agreements has arguably triggered this rush, is moving on with its ambitious program of announced regional deals, including with Russia. It has partnership agreements with all other European countries except Albania, Bosnia, Croatia, and Yugoslavia. It also has deals with Turkey, Israel, and Morocco. It is negotiating agreements with most other Arab countries.

Further afield, the European Union has struck deals with Chile, Mexico, and South Africa. It is pursuing agreements with the four Mercosur (Southern Cone Common Market) countries. It is also pressing 71 African, Caribbean, and Pacific (ACP) countries, mostly ex-colonies, to sign up to new regional arrangements.

Taking into account the 100 or so other poor countries covered by the Generalized System of Preferences, the European Union's network of preferences already covers most of the world. In fact there are only six

Renato Ruggiero is chairman of Citigroup Switzerland and was director-general of the World Trade Organization from 1995 to 1999.

countries—Australia, Canada, Japan, New Zealand, Taiwan, and the United States—with which it trades on a “normal” (most favored nation) basis.

The second big development is that Japan’s rallying to the regional cause has sparked wider moves toward regionalism in Asia. In the aftermath of the failure to launch a new round of WTO talks in Seattle in late 1999, Japan announced that it too was going regional—and it has since concluded a bilateral deal with Singapore. Also India is proposing its own free trade agreement with ASEAN (the Association of Southeast Asian Nations).

The third and very significant development is that the United States has embraced the regional route with gusto. Spelling out America’s new trade strategy, Robert Zoellick, the US trade representative, explained that President Bush has been pressing ahead with trade liberalization globally, regionally, and bilaterally. By advancing on multiple fronts, the US is creating a competition in liberalization, placing America at the heart of a network of initiatives to open markets.

The idea behind this strategy of “competitive liberalization” is that not only are US bilateral and regional agreements valuable contributions to freeing trade in themselves, they also put pressure on other countries to push forward with freeing trade multilaterally at the WTO.

Let me be clear: regional trade agreements are certainly not forbidden by the WTO and they can sometimes be very positive. The North American Free Trade Agreement has locked in Mexico’s economic and political reforms. From a US perspective, it has helped stabilize a volatile neighbor with which America shares a 2,000-mile border. The European Union has cemented peace in Europe. It is building a single market with a single currency that promises huge economies of scale for companies and the benefits of increased competition, such as lower prices, for consumers. It has helped countries, such as Ireland and Spain, to make very rapid and substantial economic progress. It is a testing ground and model for other countries that want to cooperate regionally. Better still, the agreed EU membership has entrenched peace and stability in central and eastern Europe.

There are certainly other positive examples of good “regionalism.” We have heard many speakers telling us the benefits of regionalism as well as its drawbacks. But this is not, I believe, the main issue. The central problem is that preferential agreements are, or should be, exceptions to the multilateral trade system and its main principle, the most favored nation clause. The very real risk is that regionalism is now becoming the preferred road to liberalization.

My concern, when I hear the announcement of a “competitive liberalization,” is that we are presenting bilateralism, regionalism, and multilateralism as comparative instruments of the world trading system.

We are giving the impression that we are considering trade systems based on preferences equal to the nondiscrimination system and that we are almost indifferent if the multilateral system will not be the winner of the competition. In other words, “competitive liberalization” could mean that FTAs can become an alternative to the multilateral system and not an exception subject to some conditionality under the rules of the WTO.

We cannot forget that the foundation of our open world economy is the multilateral trading system promoted by the United States. Its underlying principles are nondiscrimination and the lowering, and then binding, of tariffs through reciprocal bargaining.

The success of this system has been extraordinary. Between 1950 and 2001, the volume of world exports rose 20-fold and the volume of world exports of manufactures 39-fold, while world output rose sevenfold. By 2001, world trade amounted to 24 percent of global output. This multilateral system is a superb product of enlightened US self-interest.

Yet it is a cruel irony that just as the multilateral trading system has scored one of its greatest successes—China’s accession and the launch of the Doha Round—it seems to be at risk. In the same direction, Russia is fighting hard to become a member of the multilateral trade system, notwithstanding the regionalized perspectives offered by the European Union.

In reality, many of the arguments in favor of regionalism are far less convincing than they seem. For example, it is hard to see how achieving free trade is any easier in a vast regional arrangement like the Free Trade Area of the Americas—which covers all but one of the 35 countries in the Americas, which differ greatly in size, outlook, and level of development—than in the WTO.

It is scarcely credible that agricultural liberalization would be any easier in transatlantic talks than at the WTO. And it is not obvious how trade disputes between, say, China and the United States could be more easily managed in the Asia Pacific Economic Cooperation forum than in the WTO. Where regional agreements involve the same countries with the same interests and the same sensitivities—regardless of the context—it is arguable that overlapping rules and jurisdictions make international trade relations even harder to manage, not easier.

Competitive liberalization thus could be counterproductive. The race for regional advantage between the United States, the European Union, and others might become a substitute for, rather than a complement to, multilateral liberalization at the WTO. Negotiating bilateral and regional agreements can divert attention and effort from the Doha Round. This in turn can create a vicious cycle, whereby a lack of progress at the WTO spurs a greater emphasis on bilateralism and regionalism, which in turn further hampers efforts in Geneva. A strategy of competitive liberalization might thus in fact lead to a fragmentation of the world trade system rather than freer global trade.

As a matter of fact, the risk is that we are moving toward “competitive regionalism.” The nightmare scenario could be a world split into defensive, even hostile, regional blocs. There is a political dimension in the regional blocs that must be carefully considered.

In any case, regional and bilateral deals are a poor second-best to global free trade. By definition, preferences granted to some are handicaps imposed on others. Countries that are excluded from such agreements suffer. Yet the deals create their own logic, whereby those who are discriminated against seek their own preferential deal.

The tangled web of preferential agreements that countries are weaving, each with their own differing tariff rates, rules-of-origin requirements, and industrial and health regulations, threatens to tie the world economy up in red tape, distorting the pattern of trade and creating huge new administrative burdens for exporters—not to mention opportunities for corruption.

Although WTO rules do allow regional agreements, they are supposed to meet certain conditions: they must cover “substantially all trade,” eliminate internal trade barriers, and “not on the whole” raise protection against excluded countries. In other words, regional integration should complement the multilateral trading system, not threaten it.

Unfortunately, although few regional deals meet these criteria, the WTO is doing nothing about it. Since it was set up in 1995, the WTO’s Regional Trade Agreements Committee has failed—because of lack of consensus—to complete any of its assessments of whether individual trade agreements conform with WTO provisions.

WTO ministers recognized this in their Doha declaration, which mandates negotiations aimed at “clarifying and improving disciplines and procedures under the existing WTO provisions applying to regional trade agreements.” The problem is that this will apply only to future regional agreements—in effect, letting all the many existing agreements off the hook.

What to Do?

I have the pleasure to be a member of an informal private group called “Shadow G-8,” chaired by Fred Bergsten. It is a group of very authoritative personalities that produce every year a document for the leaders participating in the summit. I can say that our work is highly regarded and that some of our ideas have been accepted by the G-8.

This year, we have produced a very good report, and I would like to tell you about one of the main messages we have sent to our leaders about the relationship between regionalism and multilateralism.

The G-8 leaders should reaffirm their commitment to give priority to the multilateral system, seeing any regional and bilateral agreements they pursue in that

broader context and making sure that they structure those agreements in ways that are compatible with their global obligations. In addition, the leaders should agree that any Free Trade Agreements that they conclude will be comprehensive in scope, including agriculture, to assure their conformity with the WTO. They should also instruct their Trade Ministers to devise the most effective methods available, including possible amendments to the charter, to substantially strengthen the WTO rules that govern regional and bilateral agreements in order to ensure that they do not deviate importantly from the goals and precepts of the multilateral system.

This could be a commitment that, if agreed on by the leaders of the G-8 and implemented by the trade ministers, could make the idea of competitive liberalization much more acceptable and transform it into “complementary liberalization.”

The responsibility for saving the multilateral system does not lie solely with the United States. In trade terms, America is not the only superpower. Europe too has a vital role to play. All too often, the European Union has been a reluctant liberalizer. Now Europe has to prove its commitment to multilateralism, the WTO, and the Doha Round and has to negotiate meaningfully on agriculture. It is the sine qua non of a successful Doha Round, even if not the only requirement—a key demand for developing countries and rich-country exporters alike, the centerpiece without which progress in other vital areas, such as services and manufacturing tariffs, is impossible.

Conversely, if agriculture is to be liberalized, this can only be at the WTO, where the European Union and Japan can trade off liberalization for greater access to all their trading partners’ markets. My personal experience at the WTO has been that if Europe and the United States are divided, all the other members of the WTO are divided. If they are united, they facilitate the consensus. This is not an automatic consequence, but a precondition to a successful negotiation.

The timetable of the Doha negotiation is now very tight. All the major trading partners have to concentrate all their energies on the success of the round and on respecting the timetable, beginning at Cancun. It would be extremely important if, together with the commitment of the G8 leaders that we have proposed, there could be an informal consensus to a standstill for every new preferential agreement negotiation up to January 1, 2005. A regional peace clause!

With such a consensus, the very useful US proposal to eliminate all of the tariffs on industrial products by a certain date (perhaps 2015 or 2020) would also be seen as a real commitment to the success of the Doha Round and to the superiority of the multilateral trade system.

The economic case for the Doha Round was always compelling. But the stakes are now much higher: the future of our open world and the multilateral system.

Comment

GUY DE JONQUIÈRES

The pros and cons of free trade agreements (FTAs) are one of the most divisive topics in the trade policy world. Nonetheless, there are some points of common ground:

- FTAs are intrinsically discriminatory. But analysts sharply disagree over whether that is a plus or a minus factor from the perspective of the global trade system.
- Individual FTAs are so different that generalizations about them—except of course this one—are of very limited value.
- Politics are at least as important a driving force as economics. But there are widely divergent views on whether successful agreements depend on the political horse pulling the economic cart or the other way around.
- FTAs vary greatly in quality, in terms of both the scope of reforms and issues covered. I'll come back to that point in a moment.

It is worth asking why some FTAs achieve more integration than others. Apart from their specific provisions and the effectiveness of implementation, the evidence suggests two other factors play an important role. One is geography, the other is the relative economic development of the participants.

That is the lesson of the two most successful and largest arrangements thus far. In the European Union to date, both elements have been present;

Guy de Jonquières is the world trade editor of the Financial Times, London.

in NAFTA, economic disparities between members have been offset by their geographic proximity, which has facilitated flows of US foreign direct investment (FDI) into Mexico.

If these two elements are indeed central, they raise interesting questions about how far many FTAs currently under discussion—particularly inter-regional ones—will actually succeed in advancing economic integration, particularly when contending with the formidable problems of agriculture.

At the core of debate is one critical question: will bilateralism and regionalism reinforce the multilateral system—or will they undermine it?

The proposition that FTAs support multilateralism rests on two main arguments. One is that if everybody heads off in different directions, they will eventually end up in the same place. The other is that experience during the Uruguay Round suggests that bilateral or regional initiatives can jump-start multilateral negotiations.

Both arguments strike me as debatable. First, there is no compelling reason to suppose that all roads will necessarily lead back to multilateralism—unless we are prepared to undo and relearn all the lessons that led to the creation of the multilateral rules-based system in the first place.

Second, while it is true that past rounds have been launched as a US response to successive EC enlargements, times have changed. In those days, the United States regarded FTAs as the devil's work, and the General Agreement on Tariffs and Trade (GATT) as the exorcist. But today Washington is right in there, stirring the cauldron with the zeal of the recent convert.

Nor am I convinced that the creation of NAFTA and APEC (the Asia Pacific Economic Cooperation group)—and the clear implication that the United States had options if others refused to play ball in the GATT—was decisive in pushing the Uruguay Round forward. I am not saying it played no role. But what actually unblocked the Uruguay Round was the European Community's decision to move on agriculture. And it did so as much for internal reasons, arising from the unsustainable budgetary cost of the common agricultural policy, as for external ones.

What I think is not perhaps fully appreciated inside the United States is the wider global impact of its recent enthusiasm for FTAs. The United States is not just another player. It is the architect of the global trade system and by far the world's largest economy. By embracing FTAs as complementary—if not indeed an alternative—to the World Trade Organization, it sends strong political signals, particularly when Washington's commitment to other multilateral forums is in doubt. At the very least, it adds powerful impetus to the FTA bandwagon by providing further encouragement for other, smaller passengers to jump on it.

Now, I understand the reasons for this shift, though one aspect of it still puzzles me. FTAs have traditionally been tools of the weak. The European Union, for instance, has long used them as a substitute for a common foreign policy. Other, smaller and more vulnerable nations have used them

to enhance their security by seeking protection under the wing of bigger and stronger countries—as many are doing today. But why does the United States feel a need for FTAs when its military, political, and economic might are unchallenged worldwide?

One answer given is that preferential trade arrangements offer a quicker route to liberalization than does the WTO. But do they—and for whose benefit, exactly? Jeff Schott argues that the United States and European Union have little left to give in terms of market access—except a few notable barriers that have survived reform in previous GATT rounds. However, many developing nations recognize that these restrictions affect their principal exports to industrialized countries.

Furthermore, even if some tariffs are reduced in FTAs, the problem pertaining to rules of origin remains. The costs of complying with these rules can be so high for many poor countries, above all for smaller exporters, that they are in fact prohibitive. As an admittedly extreme example, less than 5 percent of Albania's exports to the European Union that are eligible for preferential treatment actually receive it.

It has been suggested that the WTO should streamline the rules on rules of origin. But that would likely involve lengthy negotiations. It seems a very roundabout route to dealing with a problem that could be tackled much more directly by agreeing to scrap industrial tariffs altogether.

FTAs also discriminate between developing countries. They create not only economic but also political divisions. Just look at how the European Union is seeking to line up its African, Caribbean, and Pacific (ACP) client states against liberalization in the Doha Round, on the grounds that it would undermine their existing preferences.

Another claim for FTAs is that they push forward the frontiers by acting as laboratories for WTO-plus innovations. This is indisputable: some ideas pioneered in NAFTA and other regional agreements have been embodied in multilateral agreements. But that does not mean that WTO-plus automatically means superior—particularly in the regulatory field, where there is a danger of larger WTO members turning to bilateral trade deals to advance self-interested agendas because they have failed to get them accepted in the WTO.

The European Union is using bilateral agreements with, for instance, South Africa to entrench protection of geographical indications of wines and spirits. I doubt that the United States or most Cairns Group members regard that as a positive innovation—any more than the great mass of developing countries would welcome WTO agreements on labor standards and the environment.

Furthermore, perceptions of desirable WTO-plus provisions are highly subjective and fickle. In the Multilateral Agreement on Investment (MAI) negotiations, the United States insisted that investor-state dispute mechanisms were essential to achieve a “high-standard” investment agreement. But when it dawned on Washington that foreign companies could use those

same mechanisms to override US courts, it swiftly reversed itself. And how many members of Congress who supported the creation of strong WTO dispute procedures are equally enamored of them now that other countries are repeatedly using them to challenge US laws?

Many would agree that dealing with cross-border regulatory differences, both bilaterally and in the WTO, is one of the biggest long-term challenges facing trade policy. It is not obvious, to say the least, that these differences will be any easier to resolve if the largest WTO members insist on exporting their own regulatory “models” to FTA partners—a practice that could increase friction and ultimately produce gridlock.

Renato Ruggiero argues strongly in this volume against leaping into FTAs out of a belief that the multilateral trade system has failed. I agree with him, though my perspective is slightly different.

It is at least arguable that the WTO is in difficulty because of flagging political commitment, not the other way round. The recent enthusiasm for FTAs risks accelerating that drift, and not just because they absorb so much negotiating capacity. They also divert political attention. Because FTAs appear to offer quick economic and political dividends, presidents and prime ministers of all stripes are eager to associate themselves with them, whether on golf courses in Brunei or through photo ops in the White House Rose Garden.

By contrast, achieving global liberalization is a long, grinding, and unglamorous process, littered with painful political compromises and land mines. When was the last time a world leader actually bothered to attend an important WTO meeting? As I recall, it was in 1999 when Bill Clinton visited the Seattle ministerial—and the result was hardly encouraging.

The biggest potential threat facing the multilateral trade system, it seems to me, is not that governments will deliberately spurn it, but that they will take it too much for granted and suppose that it will somehow carry on just the same. But that is a perilous assumption. There are good reasons to believe that without regular injections of political impetus and renewals of commitment, it not only will not advance but also will go into reverse. That fear was one of the most powerful drivers behind the launch of both the Tokyo and the Uruguay Rounds.

Fred Bergsten famously coined the “bicycle theory” to describe the phenomenon: if you stop pedaling, you fall off. And there is no doubt that, right at the moment, the WTO is pedaling very slowly. But it is not obvious to me that the solution is to get off your old bike—or exchange it for a tricycle—and head off in quite a different direction. Or at least before you do, you should be quite sure that the reason your new route looks easier is not because it is actually downhill.

