Lowy Institute Paper 07

the new terms of trade

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Program Director, International Economy
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PO Box 7143 Alexandria
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info@longmedia.com.au
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Mark Thirlwell is Program Director, International Economy at the Lowy Institute for International Policy. Before joining the Lowy Institute he worked on international economic issues at the Bank of England, J P Morgan and most recently at the Australian Export Finance and Insurance Corporation. He has degrees in economics from Cambridge and Oxford universities.

Executive summary

Australia's terms of trade have changed significantly in recent years. This is true in the technical sense, in that there has been a run-up in the ratio of export to import prices, which reached a 30-year high in early 2005. But it is also true in a broader sense, in that the terms on which we engage with the rest of the world through international trade have changed as well, with the birth of a new global economy reshaping the international context for trade and trade policy. Moreover, Australian trade policy has undergone a significant shift of its own: when the Australia–United States Free Trade Agreement entered into force at the start of 2005, it signalled the end of a fierce policy debate and confirmed a fundamental adjustment to Australia's trade strategy.

This Lowy Institute Paper seeks to describe the new terms of trade and outline some of the challenges they raise for Australia. Its aim is to sketch a picture of the current trading environment, to ask how we got to where we are now, and to think about some of the implications for the future.

The new terms of trade

The new terms of trade are a product of several developments, including some substantial changes in the structure of international trade at the global level. These comprise the increasing share of trade in world output, the expansion of trade into new areas such as services, the intensifying links between trade, foreign direct investment and international production chains, and the arrival of 'new' trading powers such as China and India. These structural shifts have in turn contributed to a transformation in the international policy environment. The multilateral trading system that has supported world trade since the end of World War II is being placed under significant strain by a combination of factors that include a growing and increasingly diverse membership roll, and the rising complexity and sensitivity of trade negotiations, as well as a terrible public image. With two of the past three World Trade Organization (WTO) ministerial meetings ending in failure, and only one successful multilateral trade round concluded in the last quarter century, policymakers have been looking elsewhere for trade policy action. One result has been a proliferation of preferential trading agreements (PTAs), with hard-to-assess, but possibly troubling, implications for the future of the international trading system.

To these global trends can be added changes in the regional environment in East Asia. Here too there have been important developments, including the expanding importance of intra-regional trade and the spread of PTAs into a region that had (until recently) been one of the last bastions of multilateralism. Perhaps the most striking development, however, has been the way in which the mounting economic and political weight of China has exerted a gravitational pull on the rest of East Asia, influencing both regional trade flows and institutions. Since roughly half of all Australian merchandise trade is now with East Asia, these developments are a crucial part of our new terms of trade.

Changes at the global and regional level have also been reflected in Australia's own trade and trade policy profiles. Thus the share of trade in output has risen over recent decades, services have become a more important part of our trade mix, China has become a key bilateral trading partner, and Australia has joined the worldwide shift to preferential trade, with three agreements signed since the start of 2003 and more under negotiation.

Managing the new terms of trade

The new terms of trade are set to provide policymakers with a whole series of tests over coming years, but three issues are likely to be particularly important:

- at the global level there is a need to first protect and then rejuvenate the multilateral system;
- at the regional level the challenge will be to respond to the evolving pattern of trade flows and treaties; and
- at the national level the task is to maximise the benefits and minimise the risks associated with the shift to preferential trade.

The most pressing issue for policymakers is safeguarding the international trading system. True, some critics argue that the WTO and the system it was created to oversee have had their day; that technology, low formal barriers to trade, and globalisation in general have together rendered the international system of trading rules irrelevant. Meanwhile others denounce the WTO for its lack of transparency and allegedly undemocratic ways. Its critics often suggest that the world's poorer and smaller countries would be better off without the pernicious influence of this 'Great Satan' of globalisation. Yet in many ways the need for the multilateral system is greater than ever. Not only is trade playing a steadily greater role in national economies as sectors once thought to be 'non-tradeable' become an increasingly important part of international commerce, but at the same time the world economy is having to adapt to the re-emergence of China and India as key players. Inevitably these developments will generate friction and adjustment strains — indeed they are already evident — and a well-functioning multilateral process is one of the best ways we have to ensure that the resulting tensions do not undermine the international trading system and ultimately the health of the global economy.

Indeed, Australia has a particularly strong interest in the continued health of the multilateral system. While trading superpowers like the

United States or the European Union (EU) may be able to operate reasonably effectively in an international economy lacking a strong rules-based framework, such an environment would be a far less comfortable place for a medium-sized player like Australia. Moreover, it is only the multilateral system that is likely to deliver any significant progress in liberalising agricultural trade, an outcome which remains a key trade policy objective for Canberra.

The immediate challenge here is for policymakers to ensure that the current Doha Round of trade talks does not end in ignominious failure; something which at the time of writing looks to be a serious risk. Ideally, saving the multilateral system should begin with saving the Doha Round. While a collapse of the Round *might* not inflict a fatal wound on the multilateral system, it would certainly come perilously close to doing so. Furthermore, even if the system did manage to survive, it would probably be crippled, leaving the repair job looking even more daunting than it does now. So in the short term yet another push to get Doha over the line is warranted. But in the longer term reinvigorating the trading system requires two more things. First, it means restoring the effectiveness of the multilateral system as a negotiating forum; that is, pushing ahead with reforms to ensure that trade rounds can once again deliver results, and do so in a reasonable time frame. Second, and in practice closely related, it involves convincing a sceptical public that the system itself is in fact *worth* saving.

While the global policy framework is of critical importance to Australia, the geographic concentration of our trade means that developments in East Asia are particularly crucial. Here the task facing Canberra is to work to ensure, as best as possible, that the ongoing process of regional trade integration and the associated policy initiatives unfold in ways that are beneficial both for Australia and for the region as a whole. This means making sure that we have a voice in the emerging regional architecture (such as the East Asian Summit) and then using that voice to continue to push for open and comprehensive regional trading arrangements. It is possible that there may even be a role here for the Asia–Pacific Economic Cooperation (APEC) forum, an organisation that has lost its way in recent years.

Finally, with Canberra's trade policy now committed, in the near term at least, to following the preferential trade approach in tandem with the multilateral route, another important policy objective is to maximise the net economic gains from that policy switch. This will require efforts to achieve the greatest possible degree of consistency across the various existing and proposed arrangements, a policy which should be accompanied by a process of submitting completed agreements to a rigorous and regular review in order to gauge their ongoing economic impact, and so stress test the effectiveness of this new trade strategy.

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List of acronyms

ABS	Australian Bureau of Statistics
ACFTA	ASEAN–China Free Trade Area
AFTA	ASEAN Free Trade Area
ANZCERTA (CER)	Australia–New Zealand Closer Economic Relations Trade Agreement
APEC	Asia–Pacific Economic Cooperation
ASEAN	Association of Southeast Asian Nations
ASEAN + 3	ASEAN, China, Korea and Japan
AUSFTA	Australia–United States Free Trade Agreement
CER	Shorter, more commonly used form of ANZCERTA
CGE	Computable General Equilibrium (model)
CIE	Centre for International Economics
EEC	European Economic Community
EFTA	European Free Trade Association
ETMs	Elaborately Transformed Manufactures
EU	European Union
EVSL	Early Voluntary Sector Liberalisation
FDI	Foreign Direct Investment
FIPs	Five Interested Parties
FIRB	Foreign Investment Review Board
FTA	Free Trade Agreement
FTAA	Free Trade Area in the Americas
FTAAP	Free Trade Area in the Asia–Pacific
GATS	General Agreement on Trade in Services

GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
GSP	Generalized System of Preferences
Hong Kong SAR	Hong Kong Special Administrative Region of the People's Republic of China
IAP	Individual Action Plan
IMF	International Monetary Fund
IP	Intellectual Property
IT	Information Technology
ITO	International Trade Organization
MFN	Most Favoured Nation
MNC	Multinational Corporation
NAFTA	North American Free Trade Agreement
NGO	Non-governmental Organisation
NIE	Newly Industrialising Economy (Hong Kong, Singapore, South Korea, Taiwan)
NTB	Non-tariff Barrier
OECD	Organisation for Economic Cooperation and Development
PTA	Preferential Trade Agreement
RBA	Reserve Bank of Australia
ROOs	Rules of Origin
RTA	Regional Trade Agreement
S&DT	Special and Differential Treatment (for developing countries)
STMs	Simply Transformed Manufactures
TCF	Textiles, Clothing and Footwear
TRIMS	Trade-Related Investment Measures
TRIPS	Trade-Related Aspects of Intellectual Property Rights
UAE	United Arab Emirates
UNCTAD	United Nations Commission on Trade and Development
VER	Voluntary Export Restraint
WTO	World Trade Organization

Preface

The entry into force on 1 January 2005 of the Australia–United States Free Trade Agreement (AUSFTA) marked a watershed in Australian trade policy. True, AUSFTA was not Australia's first preferential trade agreement (PTA): a deal with Singapore had entered into force in July 2003, and the 1983 Closer Economic Relations (CER) agreement with New Zealand marked an even earlier foray into bilateral arrangements. But neither of these sparked the heated argument that was triggered by the decision to negotiate AUSFTA, a trade deal which both supporters and opponents agreed would signal an historic shift in the strategic direction of trade policy.

One important debate on the merits of AUSFTA in particular, and of signing up to PTAs in general, focused on the evolving international context for trade policy. Did the new direction in Australian trade policy make sense given a changing world? To what extent had the external environment for trade policy altered? Did the requirements imposed by a new global economy and evolving international policy conditions change the calculus of signing up to PTAs? Interestingly, this trade-focused discussion could also be seen as part of a broader debate about the strategic direction of Australian policy in general, given a changing international environment.[1]

This Lowy Institute Paper seeks to contribute to both of these discussions, but particularly the first, by examining how the conditions under which international trade takes place have changed. To this end it asks: 'What do the new terms of trade look like?'[2] Usually when economists talk about the terms of trade, they are referring to the formal definition of the ratio of export to import prices.[3] Here, however, we are using the term to capture a broader concept: the global, regional and national context within which Australian trade policy is formulated. This context includes both the structure of trade flows themselves and the policy framework through which those flows are channelled. Changes in the features of the landscape of international trade are creating the new terms of trade.

The rest of this Paper is divided into three parts. Part I begins with the big picture, and looks at the changing *global* context for trade policy. Chapter 1 highlights the way in which trade has spearheaded a process of international economic integration that in turn has contributed to the development of a new global economy. It then reviews some of the major structural changes in international trade flows associated with that process, including shifts in the direction and composition of trade, the growing 'tradeability' of services, and the emergence of new trading powers and regional trading blocs.

Parallel to these changes in the structure of trade flows have come shifts in the international policy framework. Chapter 2 outlines the origins and subsequent evolution of the current multilateral system, and describes some of the stresses and strains that are now coming to bear on the organisation that implements the rules of the game, the World Trade Organization (WTO). Chapter 3 then concludes the discussion of the global context by focusing on one of the products of the difficulties facing the multilateral system, as well as a possible contributing factor; the recent worldwide proliferation of PTAs. It discusses PTAs in theory and practice, explores some of the reasons for the explosive growth in the number of these agreements, and assesses possible consequences for the future of the international trading system.

In Part II the Paper's focus narrows from the global to the regional landscape and looks at developments in East Asia. There are two reasons for this regional focus. First, East Asia is at the heart of many of the global trends — the emergence of new trading powers and the

proliferation of PTAs — described earlier. Second, the region is now Australia's major trading partner.

Chapter 4 describes the shifting configurations of regional trade. It begins by reviewing the interaction between East Asia and the rest of the global economy, and then looks at the way in which trade flows have evolved within the region, describing how the rise of China and growth in intra-regional trade, together with the expansion of region-wide production networks, is contributing to new patterns of trade. Chapter 5 then looks at how these developments have contributed to changes in regional trade policies, and in particular how PTAs have spread to East Asia. Both chapters illustrate the growing economic (and political) weight of China which increasingly exerts a gravitational pull on the rest of the region, moulding both trade flows *and* trade policies. This is a key feature of the new terms of trade.

Part III tightens the focus again, and concentrates on developments in Australia. Chapter 6 outlines the Australian counterparts to the changes at the global and regional levels, sketching the shifts in Australia's trading partners and in the makeup of Australian trade flows. It also provides a brief review of how Canberra's trade policy has evolved, emphasising the recent move to preferential trade, and the debate over AUSFTA that accompanied this transition. Chapter 7 concludes the Paper with a look at some of the implications for Australian trade policy thrown up by these new terms of trade.

Part I

The global context

Chapter 1

World trade in transition

The changing structure of international trade

The global context for Australian trade and trade policy is a product of the structure of international trade flows, and of the international trade policy architecture. This chapter focuses on the changing structure of international trade, while Chapter 2 and Chapter 3 track the evolving policy framework.

The structure of international trade has altered significantly at the global level, and while many of these shifts in trade represent the continued development of long-term processes, rather than sudden changes in the international environment, it is also possible to point to some developments that are more recent in origin. After a brief review of the links between rising international economic integration and the idea of a new global economy, this chapter looks at the new terms of trade in three broad areas:

- the relationship between trade and output;
- the composition of trade; and
- the shifting geography of trade flows.

A new global economy?

Perhaps the most fundamental way in which it is claimed that the current global environment for trade policy differs from earlier periods can be found in the assertion that trade now matters more to national economies than ever before. Indeed, such is the present depth of trade- and finance-led international economic integration that many commentators have heralded the birth of a new global economy. Daniel Yergin and Joseph Stanislaw argue that the period between 1989 and 1991, which saw the fall of the Berlin Wall and the subsequent disintegration of the former Soviet Union, prompted a 'relinking' of the formerly closed economies of the communist bloc into the international economy that 'made, for the first time since the First World War, the world economy truly global'.[4] In his paean to globalisation, *The Lexus and the olive tree*, Thomas Friedman cites an October 1998 advertisement by Merrill Lynch wishing a happy tenth birthday to the world's 'youngest economy': the global economy born with the fall of the Berlin Wall in 1989.[5]

While such claims often draw on geopolitical events such as the collapse of the Soviet Union to delineate the birth date of a new global economy, the evidence in favour of the proposition also rests on the rapid pace and broad extent of international economic integration experienced in recent years.[6] Writing at the turn of the new millennium, one economist noted that 'with the exception of human migration, global economic integration today is greater than it ever has been and is likely to deepen going forward'.[7] Similarly, in a review of world history since 1945, David Reynolds notes that '[t]he whole period is, on one trajectory, the story of a growing web of interconnectedness in travel and trade, ideas and information'.[8] The growing importance of international trade in goods, services and financial assets has been the driving force behind this integration process. In turn, the *product* of all of this integration — a new global economy — itself constitutes a significant new context for international policy, and is perhaps one of the most obvious examples of the new terms of trade.

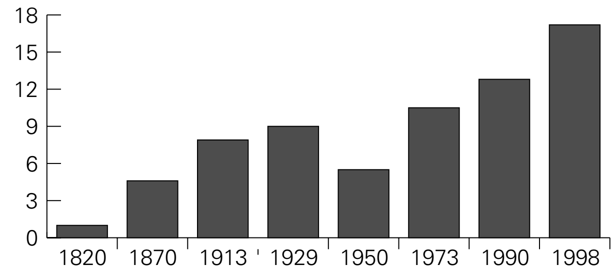
But is the current level of integration, particularly as it relates to international trade, really unprecedented? Economic historians

sometimes point to an earlier phase of international integration — typically dated between 1870 and 1913 — that was also an era of 'rapid globalization [when] capital and labor flowed across national frontiers in unprecedented quantities, and commodity trade boomed in response to sharply declining transport costs'.[9] Several observers have even concluded that 'in some ways, the world of 1914 was more tightly integrated than ours is today'.[10]

The rising share of trade in global output

One way to judge the importance of trade today relative to the past is to look at changes over time in the ratio of international trade (or more narrowly, exports) to world output. Data assembled by the economic historian Angus Maddison, which show world merchandise exports as a share of world output rising from about 4.5 % in 1870 to almost 9 % in 1913, confirm that the period sometimes called the first age of global capitalism *did* witness a significant increase in trade-led integration. However, the same data show that the share of exports in gross domestic product (GDP) by the end of the twentieth century was significantly higher than estimates for the earlier period (Figure 1.1).[11] Indeed, since trade in services has become increasingly important over time, these merchandise trade-based comparisons probably underestimate the rise in integration that has taken place.

Figure 1.1
World merchandise exports
% of world GDP



Source: Adapted from Maddison (2001)

Once the great dislocations to the international economy associated with two world wars and the economic nationalism of the 1930s had passed, growth in global trade has consistently run ahead of growth in world output (Figure 1.2). Between 1951 and 2003 world export volumes rose at an annual average rate of a little over 6 %, while over the same period world GDP grew at a rate somewhere below 4 %, a gap of almost 2.5 percentage points.

Figure 1.2
World output and trade after World War II
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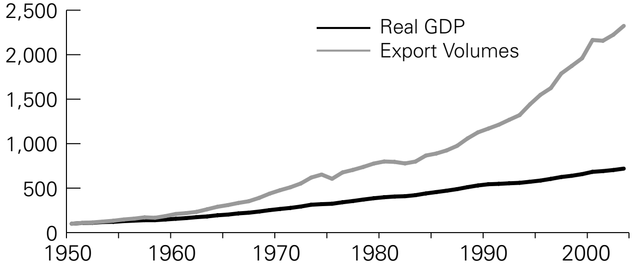
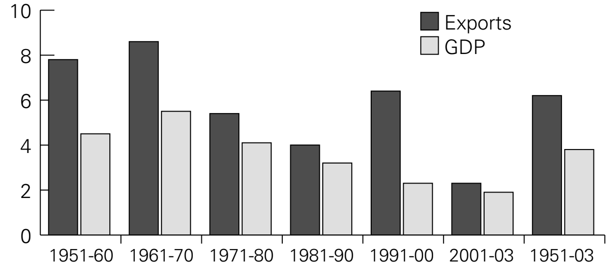


Source: Adapted from WTO international trade statistics (2004)

But while the rise in the importance of international trade relative to output is a trend that has been under way since the end of World War II, the relationship has shifted over time. In the 1950s and 1960s — a period of catch-up after war-time dislocation — world trade grew at around 3 % a year faster than world output.[12] This gap then narrowed during the 1970s and 1980s, possibly due to a combination of declining momentum for trade liberalisation and a slowdown in the rate of fall of transport costs.[13] In contrast, the period now associated with the emergence of a new global economy witnessed a marked acceleration in the rate of growth of trade volumes relative to output, with a gap of about four percentage points between the two growth rates during the 1990s (Figure 1.3).

Figure 1.3
World export volumes and GDP growth
Average annual growth rate, volumes, %



Source: Adapted from WTO international trade statistics (2003) and World trade report (2004)

This rise in the relative importance of trade was a product of several factors, including the re-integration of the formerly communist economies into the global economy, significant efforts at trade liberalisation on the part of major developing economies, and a relatively benign economic climate. However, the Asian financial crisis, followed by the bursting of the information technology (IT) bubble, actually prompted a sharp *fall* in the growth rate of international trade after 1998, and trade growth remained below average until a strong rebound in 2004.

The changing composition of trade

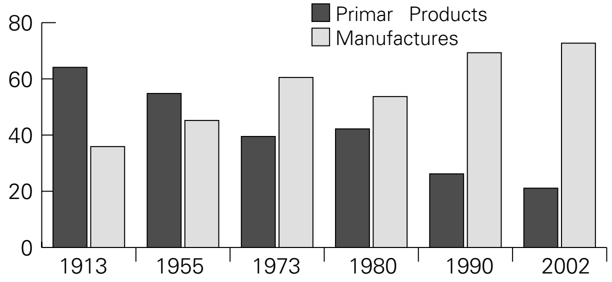
The growing relative importance of international trade has been accompanied by significant changes in its composition. These include the growth of manufacturing trade, the increasing importance of intra-industry trade and vertical specialisation, and the growing 'tradeability' of services.

The growth of manufacturing trade

One of the longest running of these changes has been a sustained, long-term rise in the share of manufactured goods in international trade (and a parallel decline in the share of primary products). Thus the share of manufactures in world merchandise exports rose from about 36 % in 1913 to 73 % by 2002, with a big increase in the share of manufactured exports in total exports taking place after 1980 (Figure 1.4).[14]

While manufactured exports continued to outpace primary products in the 1990s, between 2000 and 2003 the relative dynamism of world manufactures actually declined, mainly reflecting the adverse impact on exports arising from the bursting of the IT bubble. Recovery in the global electronics sector got under way in 2004, but the same year also brought substantial increases in the price of fuels and resources, pushing the share of resources in merchandise trade values to a new cyclical high.[15]

Figure 1.4
Composition of world merchandise trade
Share of total, %

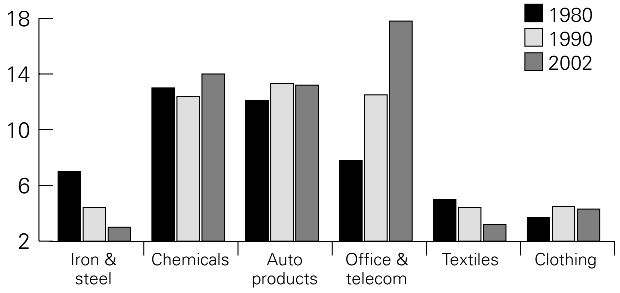


Source: Adapted from WTO international trade statistics datayase

There have also been changes *within* the manufacturing component of international trade. So while trade in manufactures overall has been the most dynamic component of goods trade, until recently the fastest growing sub-component has been trade in office and telecommunications equipment.[16] Exports in this category grew at roughly double the rate of total manufactured exports during the 1990s: the WTO estimates that gains by this group exceeded the gains made by *all* other manufactured groups combined. The share of this

category peaked at just over 20 % of total manufactured exports in 2000, but the aftermath of the global IT crash in that year saw the share of these products slide to about 18 % by 2002 (Figure 1.5).[17]

Figure 1.5
Composition of world manufacturing exports
Selected items, share of total, %



Source: Adapted from WTO international trade statistics

Rising intra-industry trade and growing 'vertical specialisation'

Both of these trends — the changing composition of merchandise trade in favour of manufacturing goods and the changing composition of manufacturing trade itself — are closely related to the growing importance of trade involving goods within the same broad industrial category. This phenomenon is called intra-industry trade.[18] Intra-industry trade covers:

- 'horizontal' trade in similar products with different varieties (for example, Australia exporting one make of car and importing another);
- trade in 'vertically-differentiated products' (for example Italy importing cheap T-shirts and exporting expensive designer suits); and

- 'vertical specialisation' (trade in similar goods at different stages of production, such as various computer parts).

Intra-industry trade has become much more important in total trade in recent years, displaying rapid growth in many economies. For example, intra-industry trade accounted for almost 70 % of total US manufactured trade in 1996–2000.[19]

This trend is particularly related to another key development: the way in which the growing *integration* of world markets has been combined with the international *disintegration* of the production process. This has led to a rise in the importance of traded inputs in the production of goods, or vertical specialisation, whereby countries 'increasingly specialize in producing particular stages of a good, rather than making a complete good from start to finish' as firms exploit different economies' comparative advantages that are specific to individual parts or components.[20] An example of this would be the laptop computer, whose parts are typically produced over an international production chain that runs across a variety of economies as countries specialise in different components with, say, memory chips made in Taiwan, disk-drives in Singapore, screens in South Korea, and final assembly taking place in China.

The spread of the resulting international production networks has been pronounced since the 1990s. Products which have seen the fastest growth rates in recent years — parts and components for electrical and electronic goods, labour-intensive products such as clothing, and finished goods with a high R&D content — are also those that have been most influenced by this effective globalisation of production. Indeed, such trade probably accounts for about one-third of world exports.[21]

Thus another defining feature of the new terms of trade has been a sharp rise in the importance of trade in the overall manufacturing production process.[22] One important facet of this process is the linkage between intra-industry trade, foreign direct investment and multinationals, the subject of Box 1.

Box 1

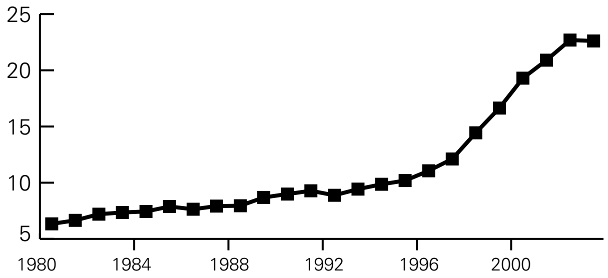
Trade, FDI and MNCs

The rise in importance of intra-industry trade has tended to be greatest in those economies which have seen high and increasing flows of foreign direct investment (FDI), emphasising the close link between trade and FDI that is another feature of the new global economy. In traditional models of trade and FDI, the two are often seen as substitutes (with companies carrying out FDI to get access to markets protected by high trade barriers, for example). In contrast, in the new global economy FDI and trade are often complementary, with vertical specialisation, for example, typically involving large-scale FDI flows into developing countries driven by firms' decisions to shift their production to new, lower-cost sites. Those firms are often multinational corporations (MNCs), with international production networks typically producing goods in several geographical locations.[23]

Neither MNCs nor FDI are new to the international economy: for example the former have had an important role in international trade that dates back to the Hanseatic League and Italian banking houses in the fourteenth century, and to the East India, Muscovy and Hudson Bay Companies in the seventeenth and eighteenth centuries. But both have become steadily more important features of the international trading landscape. In particular, flows of FDI have exploded since the start of the 1990s; from about US$55 billion in the early 1980s annual worldwide FDI inflows rose to just over US$200 billion in 1990, then rose *again*, more than six-fold, to almost US$1.4 trillion in 2000.[24] As a share of world GDP, the stock of global FDI has similarly increased dramatically (Figure 1.6).

Global inflows of FDI peaked in 2000: by 2003 global inflows had dropped to US$560 billion, following three consecutive years of decline.[25] Even so, by that year cumulative FDI inflows had produced an estimated global FDI stock of about US$7 trillion. This in turn contributed to the production capacity of more than 61,000 MNCs with over 900,000 foreign affiliates between them. These affiliates accounted for an estimated 10% of world GDP and one-third of world exports in 2003, while their total sales were around US$17,580 billion, or almost double the value of exports of goods and services.[26]

Figure 1.6
World inward stock of FDI
% of world GDP



Source: Adapted from UNCTAD World investment report (2004)

Finally, the growing importance of services is very visible in the FDI statistics. UNCTAD, for example, estimates that roughly 60% of the inward stock of FDI is now in the services sector, and that FDI into service sectors in recent years has accounted for around two-thirds of total worldwide inflows.[27]

The growing 'tradeability' of services

Another major element in the new terms of trade, and one which has the potential to be even more important than the changing nature of manufacturing trade and production, is the growing 'tradeability' of

services.[28] This has seen service sector outputs become an increasingly important part of international exchange, despite the fact that in the past many services were thought to be *non*-tradeable almost by definition.

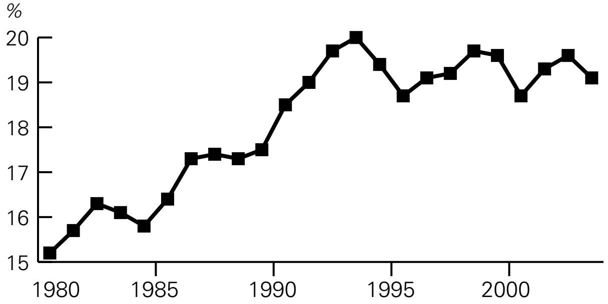
In fact, between 1980 and 2003 world trade in commercial services actually grew faster than world trade in goods, with services exports growing at a compound annual growth rate of a little less than 7%, compared with around 5.5% for merchandise exports. The main period of faster growth for services was concentrated in the second half of the 1980s and the early 1990s, when the share of commercial services in total exports rose to a peak of 20% in 1993 (Figure 1.7). Since then, the services share of total exports has been relatively flat. As of 2004, commercial services exports accounted for roughly one-fifth of total world exports, or about US$2.1 trillion, compared to around US$8.9 trillion for merchandise exports. Moreover, the well-known shortcomings in measuring services trade suggest that this number is likely to be a significant underestimate, and it is possible that the under-counting of services exports and imports has grown more important over time.

Under the General Agreement on Trade in Services (GATS) four 'modes' of service trade are identified:

- mode 1 (cross-border supply) captures the supply of services across borders without either the supplier or consumer crossing borders, for example, the supply of a service via the internet or via some other form of electronic trade, or the purchase of transportation services;
- mode 2 (consumption abroad) captures cases such as tourism and education overseas, when residents of one country consume resources in another;
- mode 3 (commercial presence) captures services provided by the foreign affiliates of domestic firms; and
- mode 4 (presence of natural persons) occurs when a service supplier moves into the country of a consumer without becoming a resident.

While balance of payments data as currently collected are thought to do a fairly good job of tracking services trade under modes 1 and 2, and a reasonable job of capturing trade under mode 4, their ability to capture mode 3 trade is much less. This shortcoming is particularly notable since it has been estimated that perhaps 60 % of international services transactions occur through mode 3.

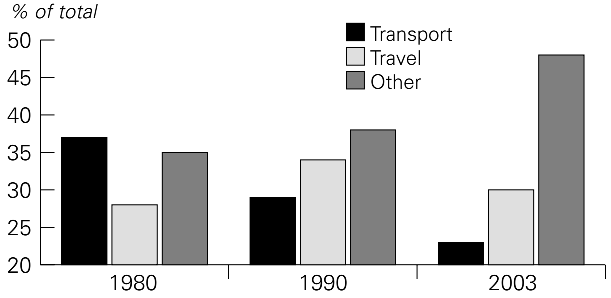
Figure 1.7
Services as share of total world exports



Source: Adapted from WTO international trade statistics

A closely related development is the changing *composition* of services trade. Transport, which used to be the most important component of services exports, has been the slowest growing category since 1980, and as a result its share has fallen from about 37 % to 23 % of total commercial services exports. In contrast, the fastest growing category of services exports has been 'other services' (Figure 1.8). Exports of these other services — led by computer and information services, financial services, and insurance — have grown particularly quickly over the past decade as the communications technology revolution has increased the number of these transactions that can occur under mode 1 trade. Again, however, there are important data shortcomings, with estimates of the 'other services' category thought to be the element of services trade which is least captured by current data collection.

Figure 1.8
Composition of world commercial services exports



Source: Adapted from WTO international trade statistics

This compositional effect is linked to another important change in the trading environment; the offshore outsourcing of service sector jobs. The international outsourcing of relatively low-skilled service sector jobs, from call centres for example, started in the early 1990s. What is more recent — and even more controversial — is that the transfer of these lower-skill roles has now been augmented by the international outsourcing of more highly skilled jobs in areas such as computer programming and financial services. To date, the amount of empirical evidence on international outsourcing for services is fairly limited, but what evidence there is suggests that — for now at least — the employment losses associated with outsourcing are quite small, relative, for example, to the number of jobs created and destroyed over the course of a typical business cycle.[29] However, the longer-term potential for service sector offshore outsourcing to reshape the international division of labour is significant, with possibly major implications for the distribution and level of real wages. Thus in the US context Stephen Cohen and Brad DeLong have argued persuasively that while the impact of globalisation on US jobs may well have been exaggerated in the past, the future impact will be dramatic, with the offshore outsourcing of services set to deliver an even greater shock than the earlier migration of large chunks of manufacturing industry to Japan that caused such angst in the 1970s and 1980s.[30]

The changing geography of international trade

Changes in the composition of global trade have also been accompanied by significant shifts in the geography of that trade. Two trends of particular note in shaping the new terms of trade in this context are the continuing 'regionalisation' of trade flows, and the emergence of new trading powers.

Regionalisation and the move to a tri-polar world

One significant feature in terms of the geography of world trade flows is the role played by intra-regional trade (Table 1.1).

Table 1.1 Intra-regional trade shares (2003)

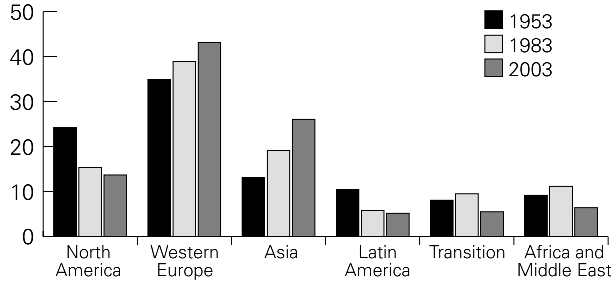
	% of region's total merchandise exports
North America	40.5
Latin America	15.6
Western Europe	67.7
Eastern Europe and former Soviet Union	24.5
Africa	10.2
Middle East	7.3
Asia	49.9

Source: Adapted from WTO international trade statistics (2004)

The tendency for trade flows to cluster into (geographical) blocs — in the sense that countries trade more with each other than with countries outside the group — has been highlighted in recent work by the World Bank. This found that while trade blocs are a longstanding feature of the geography of international trade, their number and composition has changed over time. Thus in the 1960s the structure of world trade

flows could largely be described in terms of a bi-polar world, with two trade blocs — based around Europe and the United States — effectively accounting for 80 % of global trade. By the 1970s these European and US blocs were showing signs of fragmentation, even as the economies of East Asia began to form a new bloc of their own, with Japan and Korea leading the way. The following decade saw the continued consolidation of the East Asian trade bloc, which expanded to include Australia and New Zealand. By the 1990s the world economy had clearly moved from a bi-polar to a tri-polar world, reflecting the emergence of new trading powers in East Asia.[31]

Figure 1.9
Regional composition of world exports
Share of total, %



Source: Adapted from WTO international trade statistics

This shift to a tri-polar world is visible in changes in the various regional shares of international trade. Thus the period since the end of World War II has brought a relative decline in the share of international trade accounted for by North America, a parallel increase in the trade share of Western Europe (in large part due to catch-up following the economic dislocations of the 1914–45 period), and a steady increase in the share of Asia, with East Asia leading the way. As a result, by 2003 North America accounted for just under 14 % of world exports, Western Europe around 43 % and Asia 26 %. In other words, Western Europe and North America (the old 'Atlantic economy' that dominated the first age of global capitalism described earlier) still accounted for more than half of world trade, although this was down from about 61 % a decade before (Figure 1.9), and while East Asia has become steadily more important, the share of the rest of the world has, if anything, seen a relative decline.

The emergence of new trading powers

The changing geography of world trade is also powerfully apparent in the emergence of new trading powers from the developing world. Between 1970 and 1999 the share of developing countries in world merchandise trade rose from less than a quarter of the total to almost one-third, and by 2004 it had reached 31 %. Moreover, developing countries have also become increasingly important drivers of world trade *growth*, accounting for roughly two-thirds of the increase in the volume of exports in 2003, for example.[32]

Table 1.2 The world's top ten merchandise exporters
(% of world exports)

	1953	**%**	**1983**	**%**	**2004**	**%**
1	US	18.8	US	11.1	Germany	10.0
2	UK	9.0	Germany	9.2	US	9.0
3	Germany	5.3	Japan	8.0	China	6.5
4	Canada	5.2	France	5.1	Japan	6.2
5	France	4.8	UK	5.0	France	4.9
6	USSR	3.5	USSR	5.0	Netherlands	3.9
7	Netherlands	3.0	Canada	4.2	Italy	3.8
8	Belg-Lux	2.7	Italy	3.9	UK	3.8
9	Australia	2.4	Netherlands	3.5	Canada	3.5
10	Brazil	1.8	Belg-Lux	2.8	Belg-Lux	3.4
Sub-total		**56.5**		**57.8**		**55.0**

Source: Adapted from WTO website

Table 1.2 reports the world's top ten merchandise exporters in 1953, 1983 and 2004. The *relative* stability of the world's major exporters (seven of the 1953 top ten are still present in the 2004 top ten) is apparent, but so is the rise of East Asia as an exporting power, marked first by the inclusion of Japan, and subsequently by the addition of China (two other East Asian economies are just outside the 2004 top ten, with Hong Kong in eleventh place and South Korea number 12). It is also noteworthy that only North America, Western Europe and East Asia are represented in the 2004 top ten — the highest ranking economy from the rest of the world is Mexico, in thirteenth place — and that the concentration of exports has shown little sign of declining. So although there have been changes in the geography of trade, not everything has altered.

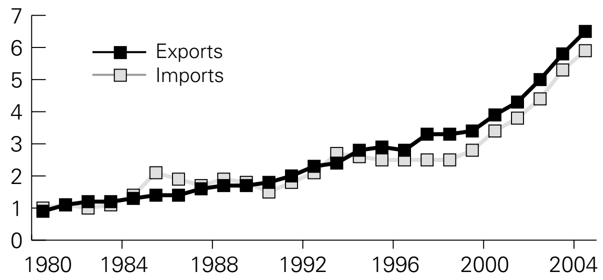
Enter the dragon …

The entry of new trading powers into the global economy is another feature of the new terms of trade. China has become an increasingly significant player in international trade, with its share of world merchandise exports climbing from less than 1 % in 1980 to about 6.5 % in 2004, while its share of world merchandise imports over the same period has risen from 1 % to almost 6 % (Figure 1.10). This increase in China's trading profile has been particularly dramatic in recent years, with China's share of world trade roughly doubling since 1998, and with the country's presence in the global trading system entrenched by accession to the WTO on 11 December 2001.[33]

By 2004 China was the world's third largest exporter and importer and its third largest trading nation overall.[34] Moreover, since the start of the current millennium, China has also been the single most important contributor to the growth in world trade.

In terms of exports, China's growing presence has been most visible in world manufacturing trade, where its comparative advantage in the production of labour-intensive products is in the process of transforming the country into the 'world's factory', to use a popular, but increasingly apt, cliché. According to the WTO's international trade statistics database, by 2003 China accounted for roughly 8 % of world manufactured exports, 23 % of world clothing exports, 16 % of world textile exports and 13 % of world exports of office machines and telecommunications equipment.

Figure 1.10
China: share of world merchandise trade
% of total



Source: Adapted from WTO international trade statistics

The relationship between trade, foreign direct investment (FDI) and multinational corporations (MNCs) discussed in Box 1 has been a particularly important part of this story, with China attracting more than US$60 billion of financing, or just less than 10 % of total world FDI inflows in 2004. The United Nations Commission on Trade and Development (UNCTAD) estimates that the stock of FDI in China now stands at more than US$500 billion.[35] Between 1994 and mid-2003, for example, a period which saw China's exports roughly triple in value, so-called 'foreign invested enterprises' (subsidiaries of global corporations and joint ventures) accounted for 65 % of the growth in exports.[36]

Initially China's presence in global manufacturing markets was most evident at the lower value end, but this too is changing as Chinese production has moved from a focus on exports of textiles, footwear, clothing and toys during the early 1990s to a greater emphasis on exports of transport and machinery, including electronics.[37] This steady progress up the value chain has led some to fear a China that

is becoming competitive across the full spectrum of manufactured products, with the likely end game that the whole of global manufacturing is destined to be located in East Asia. However, while it is certainly true that China (or at least firms located there) has become a potent competitor across a wide range of manufacturing sectors, it is also a growing market for manufactured imports, reflecting its role as an integral part of regional and international production chains.

In addition, the impact of Chinese demand has also been felt at a global level in markets for resources and energy. China is now the world's largest consumer and importer of many industrial raw materials, having displaced the United States as the largest market for copper, iron ore, aluminium, and platinum. China is also a growing importer of agricultural commodities, having recently replaced Japan as the number-two market for rubber imports, and in the future is likely to become an increasingly important source of demand for food imports.[38] Again, China is now the second largest consumer of energy in the world, with the International Energy Agency predicting that China's share of world primary energy demand will increase from around 12 % in 2003 to 16 % by 2030, and that China will account for 21 % of the growth in energy demand over this period.[39] China's demand for oil has doubled over the past decade, and in 2003 China overtook Japan to become the world's second largest oil consumer, accounting for about 8 % of global oil consumption.[40] So while the impact of increased Chinese supply is to place downward pressure on prices in the manufacturing sector, the impact of Chinese demand is also producing upward pressure on resource prices. One important implication of these demand and supply trends, therefore, is that China is contributing to a shift in international relative prices.

Importantly, China's influence on international trade flows is likely to persist for some time. Comparisons with its East Asian neighbours suggest that China's potential for further trade growth remains substantial; the recent growth performance of China's exports has been quite similar to that displayed by other regional economies: China's actual share of world exports in 2004 was roughly that reached by Japan in 1976 during its international integration process. Crucially, however, China's much greater size than its regional predecessors indicates that its ultimate influence on the world economy could well be in an order of magnitude larger than these past examples of integration.[41] For example, back in 1976 Japan's labour force was roughly half that of the US, the world's leading economy. In 2004 China's labour force was roughly five times larger than the US one. The gap between GDP per head is also notable, indicating there remains huge scope for continued 'catch-up': in 1976 Japan's level of GDP per capita was roughly two-thirds that of the US level. In contrast, in 2004 China's was less than 15 % of the US level.[42]

... and the elephant

The integration of India, Asia's other billion-people-plus economy, into the world trading system, has also accelerated in recent years.[43] While the influence of the Indian elephant on global trade flows to date has quantitatively been much more modest than that of the Chinese dragon, the qualitative nature of the Indian push into global markets has been important. In particular, a striking feature of the current Indian development model has been the central role played by services. India has been a key player in the growing tradeability of services discussed above. During the 1990s Indian services exports grew at over 17 % pa, and India has seen its share of world services exports triple in the space of about a decade. Moreover, many of these gains have come in so-called new economy sectors like software, where India's share of the global market is around 17 %, and where the growth of its exports has been double the world average. This has allowed Indian firms to compete in areas once thought to be the preserve of the developed world and to become a major force in the international outsourcing phenomenon. McKinsey estimates that Indian firms now control over half of the global IT and back-office outsourcing market.[44]

The (re-)emergence of these two Asian giants into the international economy is one of the most important features of the new terms of trade facing policymakers in the rest of the world. While their growing international economic integration is undoubtedly good news for the

overall health of the world economy, it will nevertheless bring with it major policy challenges. The combination of China's expanding presence in manufacturing and India's growth in services has led to what Morgan Stanley's chief economist, Stephen Roach, has described as a process of 'global labor arbitrage' between markets in the developed and developing world.[45] In a similar vein, Harvard's Richard Freeman has highlighted the way in which the integration of China and India into the world economy, along with the countries of the former communist bloc, has contributed to an effective doubling of the global labour force. He thinks this development could have major implications for income distribution, by placing downward pressure on wages both in the developed world and in the 'old' developing world.[46] One significant risk for trade policy is that the worldwide adjustment strains posed by these processes — which eventually could be very large indeed — will generate demands for protectionism. Indeed, the first rumblings of such a response are all too evident: witness, for example, the tension between Beijing and Washington over Sino–US bilateral trade imbalances, moves in early 2005 by both the EU and the United States to raise trade barriers against imports of Chinese textiles, and the political backlash against IT outsourcing. If such strains are not to undermine the growth in international trade and economic integration described in this chapter, then the world trading system needs to function well enough to contain and manage them. It is to this topic that we now turn.

Chapter 2

The world trading system under pressure

The changing policy framework

In this chapter we turn to the policy element of the new terms of trade, and focus on how the international policy framework that governs world trade has evolved over time. We review the origins of the current multilateral trading system and then highlight some of the strains that it is now under.

Trade policy in the first age of global capitalism

To understand the multilateral system and its current problems it helps to begin by looking back to its origins. We noted in Chapter 1 that the current period of international economic integration is sometimes described as a reprise of an earlier period of global capitalism (typically dated between 1870 and 1913) that also witnessed rapid growth in international trade. This earlier period of integration largely took place in the absence of any overarching international policy regime.

Instead, the international trade policy framework in the later part of the nineteenth century — at least in its European incarnation — rested on a network of bilateral trade agreements, starting with the Cobden–Chevalier Treaty of 1860 between Britain and France. The key feature of these agreements was the presence of a most favoured nation (MFN) clause, which meant that if one party to the agreement subsequently negotiated a trade treaty with a third party, then the other signatory to the original bilateral deal would automatically benefit from any improved treatment received by the 'most favoured nation' in any new agreement. In the years following the signing of the Cobden–Chevalier Treaty, France negotiated a series of agreements with other European economies, and the operation of the MFN clause meant that the benefits of these agreements were spread across all of France's trading partners, and hence across much of Western Europe, which in 1870 accounted for almost two-thirds of world exports.[47]

While this bilateral network of trade agreements did move Europe towards free trade, the actual contribution of trade policy to the expansion of trade during the first age of global capitalism was possibly quite limited. In part, this is because the period of free trade proved fairly short-lived: the introduction of tariffs by Germany in 1879, followed by several other major economies, meant that protectionism actually *increased* over 1870–1913. Instead, the bulk of the increase in trade flows was probably fuelled by a marked decline in transport costs, itself a product of rapid technological progress in transportation and communications, including the introduction of steamships, railroads, the telegraph and the transatlantic cable, as well as the construction of the Suez and Panama canals. The international environment did matter however, in that trade flows were supported by a relatively stable financial and political environment (at least for the major economies) provided by the gold standard and the *Pax Britannica*.[48]

The outbreak of World War I brought this stability to an abrupt end, and as one of its economic legacies left international trade subject to widespread government controls. Subsequent efforts during the 1920s and 1930s to return to the pre-war economic order proved fruitless.

Instead, the interwar years witnessed the disintegration of the international trading system as policymakers introduced a combination of protectionism and preferential regional trading agreements that proved poisonous to global trade flows.

Indeed, the 1920s and 1930s experience provides a vivid example of 'domino regionalism' whereby the formation of (in this case protectionist-minded) trade blocs is self-reinforcing. This is due to the fear of being left outside a bloc when nearly everyone else is inside, as the costs of being left out increase with the size of existing blocs. Thus in the 1920s and 1930s France pursued an active regional policy towards its colonies; Germany constructed a web of regional trading arrangements; and Britain pursued its own imperial preference scheme after finally abandoning free trade in the 1930s in the aftermath of the US Smoot-Hawley tariff hikes.[49]

The international rise of protectionism meant that quantitative restrictions affected between 50 % and 70 % of world trade by the 1930s.[50] As the international trading system fragmented, trade volumes collapsed, and by 1933 with world trade shrinking even faster than global output, economic activity fell into a downward spiral that contributed to the growing economic dislocation and rising political extremism that in turn led the world into the 'dark valley' that culminated in World War II.[51]

Learning the lessons of the interwar years

It was the powerful memory of the economic and consequent political instability experienced during the interwar years that encouraged Allied — primarily US — policymakers such as Secretary of State Cordell Hull to make the restoration of a functioning, integrated international economy a key priority for the post-World War II reconstruction effort. As Douglas Irwin puts it, '[b]y the mid-1940s, protectionism in the field of economic policy was likened to appeasement in the realm of diplomacy, a mistake that helped make the decade of the 1930s a political and economic disaster'.[52] Thus, as early as August 1941, Roosevelt and Churchill had signed the Atlantic Charter, pledging the restoration of a multilateral trading system, and even as war waged, policymakers started to plan for a post-war world in which trade liberalisation would be supported by a rules-based framework.

Many of the Allies' efforts to rebuild the international economy were given shape at a conference held in July 1944 at Bretton Woods in New Hampshire. Here delegates from 44 countries signed the Articles of Agreement of the International Monetary Fund (IMF) and established the World Bank. In December 1945 the US State Department published its *Proposals for the Expansion of World Trade and Employment*, which called for the creation of an International Trade Organization (ITO). The ITO was intended to complement the other two Bretton Woods institutions in helping to manage the world economy.[53] At the same time, 23 economies — then accounting for more than three-quarters of world trade — decided to forge ahead with trade liberalisation in advance of any agreement on the ITO. The resulting package of trade rules and tariff concessions became the General Agreement on Tariffs and Trade (GATT). The GATT entered into force in January 1948. When the US Congress refused to ratify the proposed ITO Charter in 1950, the GATT was left as the only multilateral framework governing world trade. It would continue to fill this role from 1948 until 1994, when it was succeeded by the WTO.

The GATT framework for international trade[54]

Motivated in large part by the idea that international trade policy could contribute to international security, the GATT was intended to help trade flow as freely as possible. This objective was to be pursued through a multilateral system based on negotiation and reflecting several core ideas. Chief of these would be a requirement that the international trading system should be *non-discriminatory*, an ideal embodied in two guiding principles of the GATT: MFN, which says that a member must treat all other GATT members equally, and national treatment, which says that a member should not discriminate between its own and foreign products, once the latter have entered the national market.

The requirement for MFN treatment comprises Article I of the GATT, while national treatment is embodied in Article III. Crucially, however, and despite the central importance of non-discrimination, the GATT nevertheless contained explicit loopholes and exceptions allowing for discriminatory trade policies. One of the most significant of these is Article XXIV, which permits the formation of preferential (discriminatory) trade arrangements (see also Chapter 3, Box 7). A second major exception is that the original GATT also allowed for special treatment for developing countries, a provision that over time became known as Special and Differential Treatment (S&DT). An example of S&DT is the Generalized System of Preferences (GSP) established in the 1970s and formalised by the Uruguay Round. Under the GSP advanced countries discriminate in favour of selected developing economies by offering non-reciprocal tariff reductions below MFN rates for certain products.[55]

Table 2.1 The multilateral trade rounds

Year	Round	Focus
1947	Geneva	Tariffs
1949	Annecy	Tariffs
1951	Torquay	Tariffs
1956	Geneva	Tariffs
1960–61	Dillon Round	Tariffs
1964–67	Kennedy Round	Tariffs, anti-dumping
1973–79	Tokyo Round	Tariffs, non-tariff barriers (NTBs), 'framework agreements'
1986–94	Uruguay Round	Tariffs, NTBs, rules, services, intellectual property, dispute settlement, textiles, agriculture, creation of WTO
2001–	Doha Round	Still under way

Source: World Trade Organization (2003)

The plan to reduce trade barriers through negotiation took the operational form of a series of 'rounds' of trade negotiations. Members would convert non-tariff trade barriers into tariffs and then negotiate reciprocal tariff reductions. Eight of these rounds of trade negotiations have been completed to date and the ninth — the Doha Round — is still under way (Table 2.1). Finally, GATT sought to make the international trading system as predictable and transparent as possible. Predictability was to be achieved by members making binding commitments not to reverse any previously agreed liberalisation measures without consultation and negotiation — so tariff reductions are *bound* in place — while transparency was supported by surveillance of members' trade policy.[56] Box 2 outlines the theoretical case behind establishing a body like the GATT, or its successor the WTO, and a set of rules to manage world trade.

Box 2

Why have a WTO?

'If economists ruled the world, there would be no need for a World Trade Organization.'
Paul Krugman[57]

When economists argue the case for free trade, they usually do so by advocating unilateral policy actions, since their basic point is that an economy can best promote its own interests by pursuing free trade regardless of what the rest of the world chooses to do.[58] Yet the multilateral system is based on the idea of *reciprocity*; the negotiated reduction of trade barriers at home in return for reductions in trade barriers abroad. So if unilateral trade liberalisation is in a country's best interests, why do we need a set of international trade rules and an organisation (the WTO) to manage them?[59]

One answer is that policymakers learned the lessons of history. As described above, the economic catastrophe of the 1930s persuaded them that it was vital to avoid repeating the

mistakes of protectionism and other 'beggar-your-neighbour' economic policies that had destroyed the first global economy, and the formation of the WTO's predecessor, the GATT, was a direct result of these concerns.

A second answer brings in politics. Economists might be convinced of the merits of unilateral liberalisation, but others are much less so. In the words of Martin Wolf, the general public seems to think of unilateral liberalisation as akin to unilateral disarmament: a hard sell.[60] The WTO provides a system whereby politicians can convince their mercantilist-minded constituents back home that they are not giving away something for nothing, but are rather in effect purchasing improved access to foreign markets by offering up the minimum number of concessions possible.

A third, related answer is that the WTO and the multilateral system it supports provide an institutional mechanism to solve a 'prisoner's dilemma' situation in trade policy.[61] While the best collective outcome is for all countries to sign up to free trade, for various reasons (domestic political gains, the desire to manipulate the terms of trade or to secure international rents) there will always be an incentive for policymakers in each individual country to pursue protectionist policies. In the absence of any outside enforcement mechanism, short-sighted self-interest can lead countries away from free trade. The WTO provides the enforcement mechanism.

Another answer is that by focusing mainly on the benefits of unilateral liberalisation, economists neglect the point that reciprocal liberalisation will bring even *greater* benefits. The gains to an economy from free trade come in two forms:

- gains from lowering one's own trade restrictions on imports; and
- gains arising from cuts to foreign tariffs on one's exports.

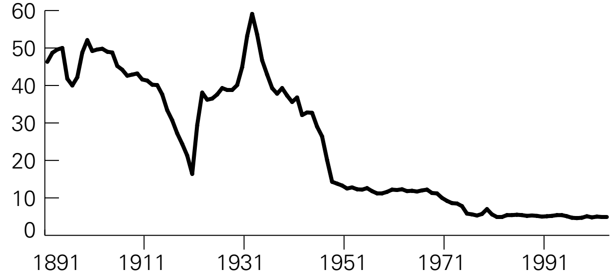
It is the second effect that provides a positive economic rationale for participation in the WTO, since it provides a benefit (cuts in barriers to exports) that unilateral liberalisation cannot deliver.[62]

A final explanation relates to the dynamics of trade liberalisation. The process of unilateral trade liberalisation can involve short run costs (as resources are re-allocated) before the longer-term gains are realised. Liberalisation by other countries at the same time can reduce these short-term costs, and therefore increase the chances that reform will go ahead and the long run benefits will be realised.[63]

There are therefore positive reasons to accept the multilateral system's reciprocal approach to trade liberalisation. However, such a model also has costs. In particular, by tending to frame the trade negotiation process in terms of trading off export 'gains' against import 'losses', it injects an unfortunate mercantilist element into the trade policy debate.

The successive rounds of multilateral trade liberalisation listed in Table 2.1 have been described as 'perhaps the most successful exercise of deliberate economic policy making in history'.[64] There is certainly a strong correlation between the creation of the GATT, the lowering of trade barriers and the growth in international trade described in Chapter 1. This is despite the fact that the initial focus of the GATT was in some senses relatively narrow: it concentrated on industrial economies and on their trade in manufactured products. Judged against this initial focus, the result was a success: by the late 1980s industrial countries' tariffs on manufactures had fallen to around 6 %, and once the commitments made by members during the Uruguay Round have been fully implemented, the overall import weighted tariff on industrial goods in industrial countries will be less than 4 % (see Figure 2.1 for the US experience). In addition, the so-called 'Quad' (which comprises the US, EU, Japan, Canada and represents the leading traders of the developed world) has now bound almost 100 % of all tariff lines.[65]

Figure 2.1
US tariff duties
Ratio to dutiable imports, %



Source: Adapted from US International Trade Commission weysite

Despite being impressive in many ways, the achievement was also a heavily qualified one. In particular, the focus on manufacturing saw agricultural trade liberalisation relatively neglected; the average MFN tariff rate for agricultural products is now two to five times higher than for industrial products.[66] Contentious issues like agricultural subsidies were also largely neglected, and even in the case of manufacturing products important sectors like textiles and clothing were treated as exceptions.

Challenges to the GATT

While there is some debate about the importance of these GATT-led reductions in trade barriers in explaining the rapid growth of trade after World War II (see Box 3), most observers would grant the multilateral trading system a reasonable share of the credit for the recovery and subsequent acceleration in international trade growth. Despite this success, however, progress under the GATT trade rounds became increasingly difficult, as can be seen in the successively longer time taken to reach agreement. Thus, the Kennedy Round ran from 1964–1967, while the Tokyo Round lasted from 1973–1979. Reasons for this rise in negotiating time included the increasing complexity of global trade, the spread of trade to new areas (such as services), the need to deal with contentious issues such as agriculture, clothing and textiles and government subsidies that had been placed in the 'too hard' basket in earlier discussions, and a growing membership roll. We return to these issues below.

Box 3

Has the multilateral system delivered more trade?

Not all economists are convinced that it is the multilateral system that has delivered rapid trade growth in the post-World War II era. In a paper that has received a lot of attention, Andrew Rose found 'that it is surprisingly hard to demonstrate convincingly that the GATT and the WTO have stimulated trade'.[67] Rose discovered that once his model of trade took into account other standard explanatory factors of trade flows such as economic distance and output, this left no room for a positive effect on trade flows for GATT/WTO membership.[68] In contrast, a response to Rose's work by Subramanian and Wei finds 'that the WTO/GATT has done a splendid job of promoting trade wherever it was designed to do so and correspondingly failed to promote trade where the design of rules militated against it'.[69]

In practice, the evidence is not straightforward. For example, the WTO's system of rules and its dispute settlement mechanism may have effects on trade policy that won't necessarily show up as changes in trade flows clustered around a country's accession date. This might make effects harder to detect in econometric modelling exercises.[70] Similarly, many countries did not immediately liberalise their trade regimes as soon as they joined the GATT or WTO, but instead did so gradually. Moreover, many developing countries were allowed for some time to combine formal membership with effectively opting out of liberalisation thanks to so-called S&DT, a point made by Subramanian and Wei. Finally, other countries have chosen to liberalise trade on a unilateral basis, rather than waiting for the WTO. The World Bank for example, estimates that roughly two-thirds of the decline in average tariffs in developing countries over the past two decades came from unilateral reductions, as against 25 % from the Uruguay Round (and just 10 % from preferential trade arrangements).[71] But whether unilateral liberalisation would have taken place in an international environment that had not already been shaped by the multilateral system is an open question.

Another factor at work was the changing commitment of the United States and other leading economies to the international system. As we have seen, right from the beginning the GATT had political as well as economic objectives, since encouraging international trade was seen as contributing to international security. Not surprisingly, a political objective requires political support: in the words of Robert Gilpin, 'since the end of World War II, the political foundations of the international economy have rested on American leadership, close cooperation among the United States and its Cold War allies, and the belief … that the open world economy did and would continue to serve their economic and political interests'.[72] To the extent that the international trading system relied on an effective *Pax Americana,* any weakening in US commitment to that system was especially problematic. Paul Krugman for example, notes that while in the early part of the post-war world a dominant US economy 'could and did both twist arms and offer system-sustaining concessions as a way of helping the GATT process work', by the 1980s the relative decline of US economic dominance meant that Washington was 'losing both the means and the desire to serve as global trade hegemon'.[73] For example, during the 1970s and 1980s when the United States felt itself under intense economic pressure from Japan, there was a marked increase in protectionist sentiment that was manifested in the form of new protectionist measures such as so-called 'voluntary export restraints' (VERs).[74]

Lengthening trade rounds and the proliferation of new trade restrictions such as VERs meant that by the mid-1980s many observers feared that the GATT system itself was crumbling, with a point of crisis approaching.[75] These fears seemed to be supported by the fact that the pace of trade-led integration — measured by the gap between the growth in trade and growth in output — had also started to slow (Chapter 1, Figure 1.3). Yet this period of angst for the international trading system was followed by the launch of the Uruguay Round in 1986. The Round negotiations concluded in December 1993 and at the Marrakesh Ministerial Meeting in April 1994 agreements were signed that 'brought about the biggest reform of the world's trading system since GATT was created', culminating in the creation of a new institution to govern international trade, the WTO.[76]

The Uruguay Round and the WTO

The Uruguay Round was both a response to the shifting international trading environment — an effort to upgrade the GATT into an organisation capable of dealing with the changing structure of modern international trade — and an attempt to deal with issues such as agriculture and textiles and clothing usually neglected under the GATT process. Thus the changing nature of international trade triggered efforts to extend rules to new areas by means of the GATS, and more controversially to trade-related investment measures (TRIMS) and trade-related intellectual property (TRIPS). A formal Trade Policy Review Mechanism was also introduced in an attempt to increase the transparency of the system. Importantly, the Round was conceived as a 'single undertaking', meaning that *all* members were expected to sign up to the various agreements. This marked an important departure from S&DT for developing counties.[77]

The Uruguay Round resulted in the creation of the WTO, a fully-fledged, formal international organisation to administer world trade rules. While the WTO replaced GATT as an international organisation, the General Agreement itself still exists as the overall treaty framework for trade in goods.[78] Box 4 outlines the structure of the WTO.

Box 4

The structure of the WTO[79]

Uruguay Round negotiations were concluded in December 1993 and the agreement signed at the Marrakesh Ministerial Meeting, Morocco, on 15 April 2004. Marrakesh produced about 60 agreements, annexes, decisions and understandings, covering some 550 pages of text.

The basic structure of the Marrakesh agreements comprises an umbrella WTO agreement that establishes the WTO itself, beneath which sit three agreements covering the broad areas of international commerce covered by the WTO: goods (GATT), services (GATS) and intellectual property rights (TRIPS). The agreements on goods and services are supported by extra agreements and annexes that list special requirements for specific sectors and issues, and by detailed schedules of commitments. Under GATT these generally take the form of binding commitments on tariffs for goods; under GATS, they are commitments stating how much access will be granted to foreign providers of services.

This series of agreements is underpinned and enforced by a dispute settlement process. Under GATT a trade complaint would be sent to a panel of experts which would issue a report. *Provided* that this report was then adopted unanimously by GATT members, the offending party would then be required either to change its behaviour or be subject to sanctions. However, the requirement for unanimity effectively gifted the offending party with a veto. The Uruguay Round strengthened the process by ensuring that a panel report could only be blocked by a consensus in *opposition* (a negative consensus), thus reversing the bias in the process.[80]

Failure at Seattle

The successful conclusion of the Uruguay Round dispelled some of the fears regarding the future of the international trading system and in the following years the system continued to record achievements. For example, the Information Technology Agreement (ITA) committed signatories to cut tariffs on IT products to zero and went into force in 1997, and the WTO agreement on basic telecommunications services took effect the following year. Despite such successes, the multilateral system remained under pressure. This reached a climax of sorts at the Ministerial Meeting in Seattle in November 1999, where members were meeting in order to get the first multilateral trade round under the WTO up and running. Instead the meeting collapsed, and did so against a backdrop of massive public demonstrations attacking globalisation in general, and the WTO in particular.

What went wrong at Seattle? The most *noticeable* development was the dramatic change in the public profile of the WTO. If in the 1970s few people seemed to even be aware of GATT's existence, by 1999 the WTO had 'become a hated symbol', it was 'the institution good people love to hate. The Great Satan of globalisation.'[81] Perhaps ironically, the increase in public animosity was a response to the very successes of the Uruguay Round. Thus the WTO after Marrakesh covered more economies than ever before and more trade (including trade in services) than ever before. It also operated a much tougher dispute settlements mechanism which was increasingly involved in sensitive issues such as food safety and the environment; areas previously thought to have been the preserve of domestic policy. By the end of 2004 WTO members had lodged 324 complaints with the organisation's dispute settlement process, a multiple of the *total* number of dispute settlement complaints lodged under GATT. As trade penetrated ever deeper into national economies, as described in Chapter 1, so too had the reach of the WTO, with the organisation seen in some quarters as en route to 'becoming a regulator of the would-be global economy'.[82]

Yet while much of the focus at Seattle was on the attention-grabbing demonstrations, in practice the collapse of efforts to start a

new trade round had more to do with the conflicting interests of the governments involved. There were two main areas of contention.[83] The first of these pitted the United States and the Cairns Group of agricultural exporters against the EU and Japan over the liberalisation of agricultural trade. Despite calls for the Uruguay Round to deliver freer trade in agriculture, actual progress had been limited, with both tariffs and domestic support for agriculture remaining high.[84] The second pitted developed against developing countries, and reflected a sense of disquiet among many of the latter about the outcome of the Uruguay Round, which they felt had imposed costly obligations on them (via the single undertaking and the end of S&DT) and had focused on issues that were not necessarily in their interest (such as TRIPS and TRIMS), while in return failing to deliver in terms of progress in areas such as agriculture and clothing and textiles. What was supposed to have been a 'grand bargain' between developed and developing economies had, they felt, instead turned into a one-sided grab.[85] So in the end, it was the inability to reach agreement on these two major issues that undermined efforts to start a new trade round, rather than the protesters.

From Doha to Cancún … to Hong Kong?

To some extent, the period between the failure at Seattle and the launch of a new multilateral trade round in Doha showed the ability of the multilateral system to respond to crisis. Thus, in order to get another multilateral round up and running, WTO members agreed to deals and compromises in some of the problematic areas raised at Seattle. For example, greater attention was paid to the implementation difficulties facing developing economies, agreements were sought on critical issues such as the relationship between TRIPs and access to affordable medicines, and negotiating procedures were reformed.[86] This collective display of (perhaps belated) concern for the future of the trading system was enough to deliver a new trade round. It also showed that the WTO membership was capable of responding to a sense of crisis about the global trading system. But despite this success, the competing pressures and agendas that had undermined efforts at Seattle continued to dog the WTO process.

Seattle undoubtedly created a growing perception that the trading system was in trouble, and although this pessimism was briefly tempered by the successful launch of the Doha Round in November 2001, the subsequent trials of the current trade round have served to reinforce the impression that the multilateral system is struggling.

Matters came to a head at the Cancún Ministerial Meeting in September 2003, when WTO members proved unable to reach agreement on even a broad negotiating framework for the trade round. Explanations for this failure have been wide-ranging, but there seems to be enough blame to go around. *The Economist* magazine for example, cited 'intransigence and brinkmanship by both rich and poor countries … inflammatory behaviour by NGOs [non-governmental organisations] … and … the deeply flawed decision-making system of the WTO itself'.[87] Several observers also wondered whether international politics had now 'contaminated' the WTO process, with some countries using the meeting to push geopolitical rather than purely trade agendas.[88]

Basically, however, the problems at Cancún seem to have reflected the same sorts of dividing lines that emerged at Seattle. In particular, the scope for reaching agreement on cuts to agricultural protection and subsidies by major developed economies remained limited. For example, a joint framework paper produced by the US and EU in August in the run-up to Cancún was interpreted by major agricultural exporters like Brazil as too protectionist in tone.[89] This in turn, along with what was seen as a fairly lacklustre response by the Cairns group to the US–EU initiative, contributed to the formation of a coalition of developing countries (the G20) led by Brazil, India and China, which would play a leading role during the negotiations. The composition and influence of the G20 was a clear manifestation of the emergence of new trading powers discussed in the previous chapter. At the same time, the developing economies were unhappy with calls by the EU and Japan to create global rules in the areas of competition, investment, government procurement and trade facilitation — the so-

called 'Singapore Issues' — which would be the *quid pro quo* for any developed country deal on agriculture.[90] With the developed countries, particularly the EU and Japan, reluctant to move on agriculture, and the developing countries opposed to the Singapore Issues, Cancún failed to reach any sort of agreement.

Coming as it did less than four years after the debacle at Seattle, the collapse of the Ministerial Meeting triggered fears about the end of the WTO as an effective negotiating forum.[91] Some observers were more optimistic, noting the stakes at Seattle (an attempt to launch the first multilateral trade negotiations under the WTO) had been much higher than at Cancún, where the problem was basically a failure to reach agreement in the middle of an *ongoing* round. After all, the Uruguay Round had suffered collapses in Montreal (1988) and Brussels (1990) but had still reached a successful conclusion.[92] This might be true as far as it goes, but there were worrying signs that some of the major trade players were losing patience with the whole multilateral process: the chief US trade negotiator, Robert Zoellick, criticised 'won't do countries' that used the WTO for political posturing, and said he would look to forge deals with 'can-do' countries on a bilateral or regional basis; EU trade commissioner, Pascal Lamy, decried the WTO's 'medieval' institutional arrangements.[93]

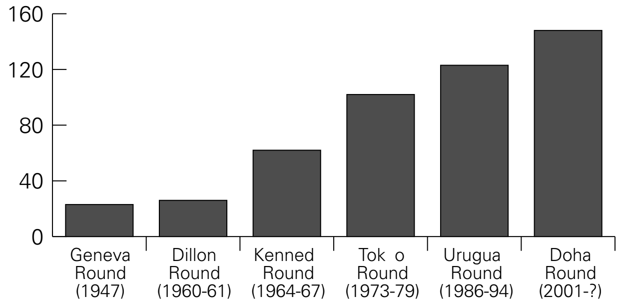
Cancún didn't sound the death knell of the Doha Round. Instead, in Geneva on 31 July 2004, the world's trade negotiators finally managed to agree on a negotiating framework. Geneva's achievements were modest, effectively consisting of little more than reaching an agreement on how to go about reaching an agreement.[94] Still, this was enough to patch things up to keep the Doha show on the road until the Hong Kong Ministerial Meeting, due in December 2005.

Is the multilateral trading system in trouble?

So what does all this mean for the health of the international trading system today, for the future of the global trade policy framework within which policymakers and businesses have to operate, and for the new terms of trade?

On the surface, the multilateral system appears to be in reasonable health. Take just two indicators: the membership of the WTO and the share of world trade accounted for by WTO members. Both are at an all-time high. Thus from the original 23 signatories to the GATT in 1947, the number of member economies rose to more than 100 during the Tokyo Round, and then to 123 in the Uruguay Round. Cambodia became the 148th member of the WTO on 13 October 2004 (Figure 2.2). More are on their way, and the WTO is heading towards something approaching universal membership. This steadily expanding membership roll suggests that countries continue to value the WTO, even as they look at other options for trade policy.

Figure 2.2
GATT/WTO memyership
No. of members, end of selected trade rounds



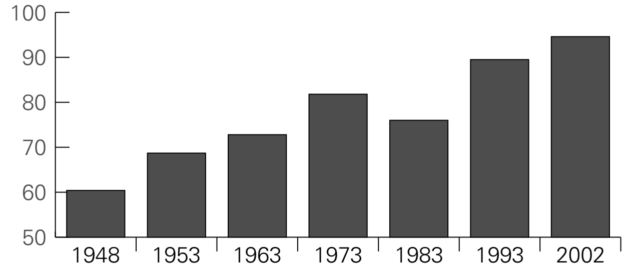
Source: Adapted from WTO weysite

Moreover, growth in membership has been accompanied by a rise in the amount of world trade accounted for by members: their share of world exports had risen from around 60 % in 1948 to about 95 % by 2002, and of imports from 53 % to 96 % over the same period (Figure 2.3).

Add these trends to several major achievements, including a steady reduction in trade barriers, a marked increase in world trade flows, the extension of trade agreements into new areas such as services and intellectual property rights, and the continued success of the disputes settlement mechanism in providing a rules-based framework for trade,

and it seems fair to say that the WTO 'arguably has become the most successful international economic organization dealing with economic relations among nations'.[95]

Figure 2.3
WTO memyers' share of world exports
%



Source: Adapted from WTO weysite

The big problem with this rather rosy view of the world however, is that these very real successes have also been accompanied by mounting internal strains and growing outside pressures.

Both are clearly visible in the faltering pace of progress under the multilateral system. While we have already noted that pauses and breakdowns in international trade negotiations are not new, nevertheless it remains the case that:

- two out of the last three WTO ministerial meetings have ended in failure;
- there has been only one successful trade round concluded in the past quarter-century; and
- progress under the current Doha Round has been glacial: a 2004 report to the WTO director-general by a consultative board of 'wise men' conceded that achieving progress during the current trade round had 'been painfully difficult and has raised questions about the process itself'.[96]

One does not have to be an advocate of the bicycle theory of international trade policy — which asserts that momentum is all, with the world either moving towards freer trade or towards more protectionism — to view this as a source of real concern. As the wise men pointed out, since at the very least the WTO is basically a negotiating machine, to the extent it becomes unable to negotiate effectively, or even is *perceived* to be unable to do so, its position becomes precarious.

What's wrong with the current system?

As noted earlier, some of the difficulties facing the WTO and the collection of international trade rules it was created to support are a product of success. The slow pace of negotiations, for example, is in part a product of the growing membership roll: reaching decisions among 148 members (and rising) is a difficult task.[97] This is particularly so since decisions are made by consensus, which in turn is a reflection of the voluntary nature of WTO membership.[98] Moreover, in contrast to the previous GATT system when smaller members could effectively opt out of some decisions, the 'single undertaking' of the WTO regime requires full participation by all members, which in turn means that more of them now have a vested interest in the outcome of negotiations.[99]

The increasing number and complexity of trade policy issues has similarly served to make negotiations more difficult and time-consuming. At the same time, the *outcomes* of negotiations have also become more sensitive for policymakers, as trade becomes a steadily more influential factor in national economies, and involves more (and different) people and jobs. Witness, for example, the protectionist rumblings produced by the US IT industry in response to the trend to outsource work to Indian providers, with several US states moving to introduce legislation seeking to ban IT outsourcing.[100]

A further factor complicating policy delivery at the multilateral level is the growing degree of assertiveness on the part of developing countries, a trend made concrete in the workings of the G20 at Cancún. As these economies have become more important players in the international economy, they have quite naturally become more reluctant to sit back

and the let the Quad (informally) run the show. One sign of this shifting power dynamic has been seen in the current Doha Round, where the role of the Quad has been to some extent replaced by that of the so-called Five Interested Parties (FIPs). Members include Brazil and India, two of the leading members of the G20.

For their part, the developed countries are no longer willing to let the larger emerging markets 'free ride' on the system: crudely put, the case for giving 'S&DT' to a trading giant like China is much harder to buy than for an impoverished African state. Moreover, the developed countries now 'have very little left to offer at the negotiating table in terms of market access, except what is very difficult to give … the protection in agriculture and textiles that has survived eight previous rounds'. At the same time, the developing countries are reluctant to lower their own — often still substantial — trade barriers without securing greater market access in return and are often particularly reluctant to grant it in those areas (like the Singapore Issues) of most interest to some of the leading developed economies. In short, the (already problematic) reciprocity dynamics of the WTO process risk running into stalemate.[101]

Yet another influence is the changing political atmosphere around trade negotiations, both at the international and at the domestic level. We noted earlier that some analysts have explained the apparent decline in the effectiveness of the multilateral system in the 1970s and 1980s as a consequence of the gradual erosion of US economic leadership. This trend has arguably been reinforced by the end of the Cold War, which, although associated with a period of increased trade liberalisation, may also have 'eliminated the security glue that compelled the largest trading countries to keep their disputes from disrupting their alliance systems'.[102] Think for example, of some of the heated trade disputes between Brussels and Washington in recent years, with the Americans and the Europeans arguing over European bans on genetically modified food, US steel tariffs, and a particularly acrimonious dispute relating to Airbus and Boeing.

The expansion of the WTO's remit into areas of traditional domestic policy has generated new political opposition from those domestic interest groups adversely affected by WTO rulings, including an increasingly vociferous *and* effective community of NGOs.[103] While the organisation itself is at pains to point out that decisions are taken by consensus and that the WTO's trade rules have all been first negotiated, and then ratified, by the member economies themselves, nevertheless as more areas of domestic policy have been opened up to challenge under the disputes settlement process, so have public concerns grown about a democratic deficit. This is based on the sense that authority over key decisions of national interest have been ceded to panels of experts in Geneva. The result is that in terms of the general public the WTO now faces a substantial image problem.[104]

Finally, there are also some fundamental problems with the underlying institutional framework of the multilateral system itself. As noted in Box 3, the very idea of reciprocity — the cornerstone of the trade rounds at the heart of the multilateral liberalisation process — is in many ways foreign to the basic economic case for free trade. The quasi-mercantilist basis of the WTO framework — the idea that trade liberalisation is a concession that is used to purchase reciprocal liberalisation elsewhere — continues to be a major shortcoming of the current system. This philosophical failing has in turn been reflected in a set of trade rules that are marred by 'inconsistencies, loopholes and flawed rules'.[105] In a framework where liberalisation needs to be, in effect, purchased by granting concessions elsewhere, it is not surprising that as countries are faced with negotiations over sensitive sectors such as agriculture, they find it progressively harder to maintain the momentum in lowering trade barriers.

The result of all these problems — the precarious health of the multilateral trading system — is another defining feature of the new terms of trade.

Chapter 3

The rise of preferential trade

Proliferating PTAs

The increasingly problematic performance of the multilateral system described in Chapter 2 has seen policymakers look elsewhere for trade policy initiatives. In particular they have turned their attention to preferential trade agreements (PTAs), typically in the form of bilateral free trade agreements and regional trade agreements (RTAs). Box 5 discusses the definition of a PTA.

Box 5

What is a PTA?

Jagdish Bhagwati makes the case for using the term 'preferential trade agreement' (PTA) rather than the term 'free trade agreement' (FTA), arguing that 'those who are used to sound bites and cannot think of more than two words at the same time will read free trade area as free trade! So, since clearly the phrase FTA is calculated to confuse it with free trade, I have urged … that economists call FTAs by the phrase PTAs'.[106]

Here we follow a definition used in the WTO's annual report, treating PTAs as 'intergovernmental treaties through which signatories agree to offer more advantageous conditions, in the conduct of their trade relations, than those applied to other, non-signatory WTO partners'.[107] Less formally, we define a PTA as a trade agreement that offers preferential market access to members of the agreement, and so effectively discriminates against non-members.

This broad definition covers various sub-categories of agreements. These include arrangements between two economies (bilateral trade agreements), groups of economies in the same geographical region (regional trade agreements or RTAs) and agreements between countries in geographically distant regions (cross-regional RTAs). PTAs can take the form of FTAs, customs unions, common markets and economic unions. Currently FTAs account for around about 90 % of all PTAs.[108]

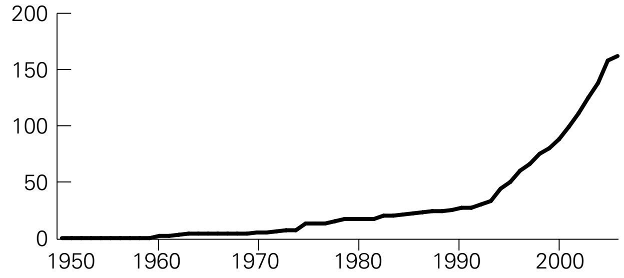
The focus of this Paper is largely on reciprocal agreements, that is, PTAs that involve an exchange of preferences. As noted in Chapter 1, there are other forms of non-reciprocal preferential trade, such as special treatment for developing countries like that provided by the GSP, which also have important effects on the international trading system.[109]

Whether PTAs are purely a symptom of the strains on the multilateral system, or in addition a contributory factor to the current malaise, is a subject that we'll turn to later in this chapter, but either way, there is no doubt that the spread of preferential trade across the world economy is another feature of the new terms of trade.

Recent years have witnessed a remarkable acceleration in the number of PTAs being formed: out of the 300 agreements notified to the GATT

and the WTO by October 2004, 124 were notified between 1948 and 1994, while 176 were notified after January 1995 (Figure 3.1). Of this 300, more than 150 are currently in force with another 70 operational but yet to be notified: the WTO reckons that by the end of 2007 the number of PTAs in operation will be approaching 300.[110]

Figure 3.1
PTAs notified to GATT/WTO
Cumulative, by year of entry into force

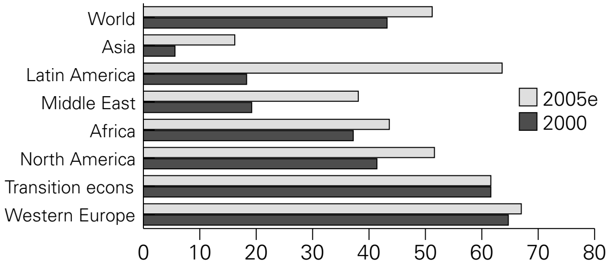


Source: Adapted from WTO weysite

By 2004 nearly every significant economy in the world — and virtually every WTO member — was involved in some form of PTA: the World Bank could find only 12 countries that did not belong to at least one such agreement, and virtually all of these were either islands or microstates. Indeed, on average, each country now belongs to *six* PTAs (although this hides substantial variations across regions and development levels).[111]

The WTO has estimated that by 2000 around 43 % of world merchandise trade was taking place within PTAs, with that share expected to rise to more than half of all world trade by 2005 (Figure 3.2). However, this estimate may be too high because the value of total trade flows between PTA partners will tend to overstate the actual trade that takes place on a preferential basis, since the tariff schedules of many PTA members include MFN duty-free rates of zero. Taking this into account, the World Bank thinks that the amount of preferential trade among PTA members is probably around 21 % of world trade. Moreover, since some firms might find it more profitable for enterprises to pay a low MFN tariff rather than deal with the various costs involved in accessing a preferential tariff, the actual share could be lower still.[112]

Figure 3.2
Preferential trade share of world merchandise imports
%



Source: Adapted from Tayle IB.10 in World Trade Organization (2003)

Despite some quibbles over the numbers, however, such has been the spread of PTAs in recent years that, in the words of a recent WTO report, 'MFN is no longer the rule; it is almost the exception'.[113]

Three waves of preferential trade

The 1950s and 1960s witnessed a series of regional integration initiatives based around PTAs. However, with the notable exception of the European Economic Community (EEC), these had little lasting impact on the international trading system.[114] PTAs fell out of fashion until the second half of the 1980s, when the drive to a single European market and moves towards a North American Free Trade Agreement (NAFTA) prompted a new burst of *regional* economic integration — the 'new regionalism' — that placed PTAs back on the agenda for policymakers.[115] This was followed by a third wave of PTAs that started to build in the late 1990s and which has yet to crest.

These three successive waves of preferential trade also involved a process of evolution in the agreements that embodied them. Thus the first concentrated predominantly on merchandise trade liberalisation

(the EEC being an exception), and while in the second the focus remained on goods trade, negotiations also expanded to include non-tariff barriers and other areas such as dispute resolution and competition policy. Finally, in the third and most recent wave of agreements the provisions governing merchandise trade have tended to be relatively less important, with a greater focus on 'new age' issues such as services, investment, and competition policy.[116]

Third wave PTAs also differ from their predecessors in another fashion. In the past, many PTAs were 'regional' in the sense that they tended to involve economies in fairly close geographical proximity. In contrast, the latest wave of agreements demonstrates much greater geographical diversity: around one-third of agreements currently under negotiation are among countries belonging to different geographical regions.[117]

Why do countries enter into PTAs?

Perhaps the most striking feature of the 'third wave', however, is the sheer number of countries now involved, which prompts the question; why have so many policymakers decided to sign up for preferential trade?

The simplest economic motive for entering into a PTA is to win improved market access from a trading partner in return for offering that partner greater access to one's own market. A slightly different but closely related incentive is a desire on the part of a smaller trading partner to 'lock in' secure access to an important larger market (for example Canada trying to guarantee access to the vital US market).

PTAs may also make it possible to tackle useful and important issues that are harder to deal with in a broader forum. The fact that PTAs provide governments with the opportunity to push agendas that won't run at the multilateral level is not *necessarily* a good thing for everyone concerned, however. Some of the features of PTAs negotiated by the United States, for example, include a focus on delivering enhanced protection for intellectual property (IP) rights beyond that offered by TRIPs and for wedging open partners' capital accounts. Yet the national welfare effects of *tightening* IP protection are ambiguous and from the point of view of other countries they could lead to large one-way transfers to the United States. Similarly, economists remain divided about the merits of full capital account liberalisation for emerging markets. Of course, the bilateral imbalance in power that allows the larger negotiating party to push such issues is another attraction of PTAs, at least for one side of the negotiating table.[118] It is quite possible that other benefits — for example securing access to a crucial overseas market — are such as to more than balance this for the smaller partner, who could well turn out to gain more in relative terms.

These sorts of motives are not new, however, and so cannot explain the recent surge in membership. Another element of the explanation, therefore, is that the third wave is a policy response to the pressures facing the international trading system outlined in Chapter 2. Advocates of PTAs point to the slow pace of multilateral negotiations and claim that PTAs provide an effective supplement to the WTO, since with fewer participants, the chances of reaching agreement are improved.

Another possible benefit is that third wave PTAs allow participants to deliver 'deep economic integration'. As international trade has changed and expanded to include services and closer ties to investment, trade policies such as tariffs have become a relatively less important impediment to trade. Instead, logistical, institutional and regulatory obstacles are often equally or more important, with systems of customs, standards and accreditation sometimes crucial determinants of market access. PTAs provide a forum in which to deal with these issues, along with the opportunity to lower barriers to services and investment.[119] There is 'considerable evidence' for example, that PTAs have succeeded in attracting FDI to member countries.[120]

The bandwagon effect

The recent surge in PTAs also seems to involve a strong self-reinforcing dynamic. This could reflect the positive demonstration effect arising from non-member economies' seeing successful PTAs such as the EU and NAFTA at work. But it is also a response to a fear of exclusion.

Richard Baldwin coined the term 'domino regionalism' to describe bandwagon effects whereby an increase in the number of PTAs encourages still more economies to either join existing agreements or create their own. The basic idea is that fears of trade and investment diversion create a kind of multiplier effect that expands in line with the number of countries engaged in preferential trade.[121] A closely related possibility is that membership is motivated by fear of being isolated in the event of international trade disputes, contributing to an additional insurance motive for being inside a (large) PTA.[122]

It's not all about economics

While the analysis so far has concentrated on economic motives for PTA membership, in practice many existing agreements have been formed for non-economic reasons.[123] In particular, it is common for economic integration — sometimes in PTA form — to be used as a tool to foster political integration. The EU is an obvious example here, but an earlier one would be the 1834 *Zollverein* (Customs Union) between German principalities. Trade-based integration has also been used to try to 'lock in' domestic reforms. These could be economic (NAFTA is often described as a mechanism for promoting Mexican reform by offering the reward of US market access) or political (EU membership for Greece, Spain and Portugal was seen as a means of supporting restored democracies).

PTAs also have a history of being motivated by security and foreign policy concerns, based on the hope that trade-led economic integration will increase the costs of conflict and hence make peace more likely. This is the kind of reasoning used by some advocates of the GATT after World War II, and in a similar way the 1860 Cobden–Chevalier treaty described in Chapter 2 was partly a product of Richard Cobden's belief that free trade could improve relations with Britain's neighbours. More recently, the European Coal and Steel agreement (the predecessor of the EU) was intended to reduce Franco–German tensions and build the foundations for a more peaceful Europe. A similar hope that increasing trade could reduce the dangers of regional conflict was also one of the motives behind integration initiatives in Southeast Asia.[124] PTAs have also been advocated for extra-regional security purposes, as countries seek to act together to manage a common external threat, hoping that trade and more general economic integration make the promise of collective security more credible. The creation of ASEAN for example, was also motivated by a fear of Communism, while the economies of Central and Eastern Europe pushed for EU membership in part because of fears of Russian domination.

A closely related aspect of the use of PTAs as a tool of foreign and security policy has been to provide support to otherwise troublesome neighbours. From the perspective of the United States, NAFTA was a mechanism for helping stabilise Mexico (and so encouraging fewer Mexicans to seek better economic prospects north of the border). Similarly, EU–Mediterranean agreements reflect European efforts to encourage economic — and hence political — stability in North Africa.[125]

These geo-strategic motives for PTAs seem to be a significant factor in some of the third wave agreements. As one observer remarks, today 'free trade arrangements are important tools of foreign policy that are intended to solidify partnerships, as military pacts did in earlier times'.[126]

Another non-economic motive for PTAs rests on the fact that policymakers may need to be seen to be delivering something for their constituents and in the absence of swift progress at the multilateral level — a trade round that takes longer than a decade could see out the terms of office of several trade ministers — a PTA can offer the benefit of a quick result and hence the associated political return. The same sort of analysis could also apply to businesses: for example corporate lobbyists needing to point to a win on trade policy may feel that PTA negotiations are more likely to deliver the kind of reasonably quick success they can show to their clients than the long slog of multilateral negotiations.

Blaming Washington?

A further explanation for the current rush to PTAs focuses on US trade policy, with Washington's decision to embrace PTAs as another tool of trade policy given central stage.[127] Robert Gilpin dates this shift in US

trade policy to September 1985, when President Ronald Reagan attacked the 'unfair' trading practices of other countries and announced a shift to a 'multi-track' trade policy that would combine Washington's traditional reliance on the multilateral system with 'aggressive unilateralism' and regional trade initiatives, a stance that would be followed and reinforced by the subsequent Bush and Clinton administrations.[128]

Even so, by the mid-1990s the United States had still signed only three PTAs (with Israel, Canada, and Mexico) and arguably each of these represented a 'special case'. The real rush to PTAs followed the first election of President George W Bush, when US trade representative Robert Zoellick articulated a policy of 'competitive liberalization' under which multilateral, regional and bilateral trade negotiations would all reinforce and complement each other.[129] Since trade promotion authority was approved in 2002, the United States has negotiated bilateral trade agreements with Australia, Bahrain, Central America, Chile, Morocco and Singapore, and started negotiations with Colombia, Ecuador, Panama, Peru, Southern African Customs Union, and Thailand.[130] As a result, '[i]n two years of active negotiations, the Bush administration … negotiated more FTAs than the United States had struck in the entirety of its history'.[131]

While the shift in policy by Washington may well have had an important demonstration effect it is harder however, to point to additional changes in US behaviour that indicate a shift in policy. In a largely sceptical review of PTAs, the World Bank for example, concludes that Washington's move to negotiate more PTAs 'does not appear to have reduced the United States' participation in the WTO negotiations, nor to have had much effect on the content of its negotiating position'.[132]

Moreover, US trade policy initiatives — particularly the changing attitude towards the trading system demonstrated in the 1980s — can be traced at least in part to a response to the trade policies pursued by the other major global traders, primarily Europe and Japan. Thus disappointment with the (lack of) reaction of these key players to Washington's trade policy concerns — as seen for example in the European approach to agricultural subsidies — has also been an important contributory factor to any US disenchantment with multilateralism.

PTAs in theory

Ideally, economic theory would provide us with some clear guidance as to whether the recent proliferation of PTAs is a positive development. Unfortunately, however, there is no clear-cut theoretical result regarding the net effect of PTA membership on an economy's welfare.

The analysis showing that the impact of PTAs on economic welfare is ambiguous dates from Jacob Viner's work on customs unions, which introduced the concepts of trade creation and trade diversion.[133] When trade is liberalised on a preferential basis, the fall in barriers to trade between member countries prompts trade creation. At the same time, however, the rise in effective discrimination against non-members can also lead to trade diversion, whereby existing trade is diverted from non-members to members. Viner's insight was that a PTA could either increase or reduce the economic welfare of a participating economy, depending on which of the two effects dominated.[134]

This basic theoretical result — that a country will tend to gain from a PTA provided it leads to more trade creation than trade diversion — has been augmented by subsequent work, including the propositions that the higher the level of general tariffs before the introduction of a PTA, the greater the likelihood of trade diversion;[135] and that if PTAs bring together countries that are already major trading partners, the probability of trade diversion may be lower.[136] More recently, theoretical models have allowed for imperfect competition and economies of scale, significantly increasing the complexity of the welfare analysis involved.[137] Finally, it can be shown that the fact that a PTA leads to net trade creation is a necessary but not sufficient condition for it to boost a member country's welfare.[138]

The way in which third wave PTAs have gone beyond tariff reduction and goods trade to cover areas such as services and foreign investment has also influenced the debate. For example, liberalisation of services can have a significant positive impact on economic growth, via lower prices, higher quality and increased variety. Including services might seem to strengthen the case for PTAs. Thus by granting greater access to foreign providers, PTAs increase competition, which in turn means

that countries are very likely to gain. And in contrast to merchandise trade there is typically no loss associated with foregone tariff revenue following trade diversion, since most service sector barriers are non-monetary. However, there is a risk that preferential access could produce 'first mover' advantages which will make it difficult for lower cost producers from third countries to enter the market in the future.[139]

PTAs can also spur investment, with additional positive effects on growth. This however raises the question — parallel to the trade debate — of whether PTAs are investment-creating or merely investment-diverting.

Finally, the adverse consequences of the rules of origin (ROOs) needed to make some versions of PTAs work also need to be taken into account. Box 6 discusses the role of ROOs in PTAs.

Box 6

Rules of origin

In PTAs whose members retain the ability to apply different levels of external protection, ROOs are required to make the agreements operational. (Thus FTAs for example require ROOs while customs unions (which have a common external tariff), do not.)

ROOs set out specific requirements — for example a minimum level of value-added created in a member economy — that have to be met before a good can receive access under a PTA. They are designed to stop non-signatories benefiting from preferential access by trans-shipping their exports via a member country (for example by sending Korean cars to the United States via Mexico to benefit from access under NAFTA); a phenomenon called trade deflection. ROOs can be extremely complex (NAFTA requires more than 200 pages to detail its ROOs) and can create substantial compliance and other transactions costs, and in some cases can effectively rule out trade altogether.[140] However, if MFN tariffs between trading partners are already fairly low thanks to existing WTO commitments, the significance of ROOs as a drag on trade becomes much less important, since if the compliance cost of meeting ROOs proves to be significant, traders can simply opt for trade at the MFN rate. ROOs are also *relatively* less important in third wave PTAs, since they tend to apply most strictly to trade in goods.

The particular design features of a given set of ROOs have an important effect on the quality of a particular PTA. The World Bank points out that both EU and US PTAs tend to feature different ROOs for different products ('product-specific' ROOs), which increases the scope for protectionist gaming of the requirements. The cost of meeting some ROOs, arising from the need to use more expensive local inputs and the administrative burdens, can offset any gains from preferential tariffs cuts.[141]

Guidelines to reduce the adverse impact of ROOs — for example by avoiding product-specific ROOs and by choosing rules such as a change of tariff heading or a value-added rule, for which compliance costs are lower — are available. But there is a more fundamental problem. The very idea of ROOs runs directly counter to the growing trend toward international vertical specialisation discussed in Chapter 1, since they work to reduce firms' ability to source different stages of production in different countries.

This theoretical ambiguity has left economists divided on the merits of PTAs. Larry Summers, for example, has argued that 'economists should maintain a strong, but rebuttable, presumption in favour of all lateral reductions in trade barriers, whether they be multi, uni, bi, tri, plurilateral'.[142] On the other side of the debate the eminent trade economist Jagdish Bhagwati has characterised the growth of such agreements as a 'pox on the world trading system'.[143]

PTAs in practice

Crudely put, then, theory tells us that a PTA will be a 'good thing' to the extent that trade creation exceeds trade diversion. Whether this turns out to be the case in practice then becomes an empirical matter and will depend on the specific characteristics of each individual trade agreement. Unfortunately, just as economic theory does not provide a clear conclusion as to the merits of PTAs, neither does the empirical evidence.

There are two broad sets of approaches to analysing the impact of PTAs. The first uses economic models to try to estimate the likely gains from future agreements (*ex ante* studies); the second uses econometric techniques to assess the impact of existing PTAs using historical data (*ex post* studies).

Ex ante studies typically use computable general equilibrium (CGE) models to evaluate the impact of proposed preferential deals. Their big advantage is that they capture the detailed interaction between a whole host of complex sectoral and aggregate effects. However, the results are heavily dependent on the choices that modellers make for the value of some key parameters (for example the price elasticity of demand for exports) and for how changes in trade policy are captured (it can be difficult to construct tariff equivalents of non-tariff barriers, or to model the impact of reductions in barriers to services or the cost of complex rules of origin). As a result, the findings of the CGE approaches needed to be treated with a degree of caution: ultimately they are simulations, not predictions.[144] Keeping these drawbacks in mind, the broad message of CGE studies is that on average PTAs create more trade than they divert and hence increase the welfare of member economies. For example, one survey of results finds that 'trade creation greatly exceeds trade diversion in virtually all the [P]TAs studied'.[145] Similarly, a study by the OECD concludes that these models tend to find that 'the recent wave of agreements had been trade-creating on a net basis and welfare-improving for member countries and trading blocs as a whole'.[146] However, another general result is that countries excluded from PTA arrangements typically lose out, with those losses increasing with the size of the PTA.[147]

The results of *ex post* studies also fail to provide a conclusive answer on the welfare question.[148] While many early studies supported the contention that PTAs are basically trade-creating, more recent work has called some of these findings into question, suggesting a less benign interpretation. For example, Adams et al find that of 18 recent PTAs, 12 have diverted more trade from non-members than they have created among members. Again, an OECD review of various studies found 'fairly mixed results', concluding that the diversity of outcomes made it difficult to tell whether trade diversion was a significant problem. And a 'meta-analysis' of 17 research studies by the World Bank also concludes that the overall impact of PTAs is fairly uncertain.[149]

The OECD has looked at the evidence on another claim for PTAs; that they promote 'deeper integration' than is possible under the WTO. A comparison of rule-making provisions in PTAs with those in the WTO over ten areas did find that provisions in PTAs tended to 'go beyond' provisions in the WTO. But the study also questioned whether such provisions were always better than those at the multilateral level, as opposed to merely different. Moreover, in some especially sensitive areas, the OECD found that PTAs had been no more successful, and in some cases less successful, than multilateral agreements. Similarly, a study by the WTO looking at a selection of PTAs found that so-called 'sensitive' sectors in multilateral negotiations also proved to be sensitive in PTAs, with high MFN tariffs often mirrored by high preferential tariffs.[150]

What about third wave effects such as investment creation or services trade? There does seem to be some fairly strong evidence that PTAs can generate investment. Adams et al, for example, find evidence that FDI responds to the non-trade provisions of PTAs, and that most PTAs have led to net investment creation rather than diversion. But the risk remains that trade generated from this new investment is diverted in the 'wrong' direction.[151]

The basic conclusion therefore is that both theory and practice suggest that there is a reasonable case to be made for avoiding broad brush statements about the direct welfare effects of membership in a PTA. Whether a particular agreement is welfare-increasing or reducing

in practice will depend on the specific characteristics and rules applying to that particular agreement. Some PTAs will have net positive effects, while others will be damaging to overall welfare, depending on factors such as the depth and breadth of integration involved, the prevailing MFN levels of protection and the nature of the ROOs.

Building blocks or stumbling blocks for world trade?

Despite this theoretical and empirical ambiguity, trade ministers have clearly made up their collective minds, since PTAs are now a prominent feature of the global trading landscape. So what does this mean for the already questionable health of the multilateral system? Even if membership in a PTA is welfare-improving for the country involved, any gains could potentially be more than offset if the final outcome is damage to the international trading system.

Since, by definition, PTAs embody a departure from the core MFN principle, they would seem to represent a direct challenge to the WTO (Box 7 discusses the formal relationship between PTAs and the multilateral system).[152] However opinion is divided as to whether PTAs are building blocks to freer world trade or stumbling blocks.[153]

According to the 'competitive liberalisation' argument made by some practitioners, PTAs actually *complement* the multilateral system, both by creating precedents for subsequent WTO negotiations and by encouraging laggards to agree to liberalisation for fear of being frozen out of the game: for example it is often claimed that the Uruguay Round was only completed because of the impetus provided by NAFTA to otherwise reluctant European trade negotiators.[154] Another possibility is that the deeper but narrower integration involved in PTAs can boost demand for future, broader liberalisation. It is this optimistic take on PTAs that is closest to the view held by the current Australian government, for example.

Box 7

PTAs and the multilateral system

PTAs clearly violate the principle of non-discriminatory trade at the heart of the multilateral trading system. Yet (perhaps surprisingly) the rules *do* provide for WTO members to participate in preferential arrangements, provided they meet certain conditions. These are set out in Article XXIV of the GATT (Article V is the GATS equivalent).[155] There are three main requirements:

- that the PTA in question must not 'on the whole' lead to an increase in protection against non-members;
- that it should cut tariffs within the agreement to zero while at the same time removing 'other restrictive regulations' except those justified by other GATT requirements; and
- that it should cover 'substantially all trade'.[156]

The WTO concedes that in practice not all PTAs meet the spirit (and arguably in some cases the letter) of these requirements. What's more, 'there are long-standing controversies about the interpretation of the WTO provisions against which [P]TAs are assessed, and institutional problems arising either from the absence of WTO rules (for example, on preferential rules of origin), or from discrepancies between WTO rules and those contained in some [P]TAs'.[157] The WTO also concedes that its surveillance mechanism for the formation of PTAs 'is, to a large extent, non-operational'.[158]

Multilateral efforts to regulate PTAs arguably failed at their first serious test: the GATT review of the Treaty of Rome (the agreement which established the EEC). Early findings

suggested that the Treaty violated Article XXIV, but the political pressures to allow the agreement to go ahead were huge, since European countries would have put the EEC before GATT and the foreign policy objective of reducing the likelihood of European conflict weighed more heavily than the trade policy issues involved. In the event, political realities triumphed.[159] Thus to the weaknesses in the structure of Article XXIV must be added the reluctance of the WTO to challenge agreements that fail to meet its standards.

On the other side of the debate, the fear is that PTAs will damage the multilateral system and the global trade it supports. Jagdish Bhagwati, for example, fears that the recent surge in PTA membership will have an effect similar to Gresham's Law whereby 'bad' approaches to trade liberalisation (PTAs) will drive out 'good' ones (MFN). He worries that the proliferation of PTAs is producing a 'messy maze' of agreements — a 'spaghetti bowl' effect — that not only undermines the MFN principle but also significantly complicates international transactions.[160] Critics have also charged that PTAs divert scarce negotiating resources from multilateral trade negotiations, particularly in the case of smaller countries with a limited supply of people with the requisite skills.

Another major problem is that PTAs can actually generate protectionist pressures by prompting those groups and sectors that benefit from preferential access to lobby against any further liberalisation. Thus the EU experience with the common agricultural policy and trade in agriculture is often cited as evidence that PTA members then become reluctant participants in multilateral negotiations, while at Cancún some developing countries sought to block reforms in order to secure existing (non-reciprocal) preferences in industrial markets.

Unfortunately, economic theory again provides little guidance as to the likely overall impact of PTAs on the global trading system.[161] Surveys of the existing literature tend to conclude that the results of most of the theoretical models are not particularly robust; indeed, it is possible to construct models that support either a positive or negative conclusion on PTAs and global trade. A further limitation is that very few of these models generate testable predictions about observable events. But even if they did, in practice there is little data to test them on: with the exception of the EU, it is hard to think of any trade blocs that have been long-lived and effective enough to have potentially influenced the multilateral system.[162]

All of which leaves us with a rather unhelpful bottom line. While we know that PTAs are now an important part of the new terms of trade, we are much less clear about the implications of this development. To quote from the conclusion of one review of this debate, the answer to the question whether PTAs will help or hinder the cause of global free trade is 'we don't know yet'.[163] Given the costs involved if the answer turns out to be negative, and given the current momentum behind the PTA bandwagon, this is a fairly disconcerting conclusion.

Part II

The regional context

Chapter 4

The shifting patterns of regional trade

Why focus on East Asia?

The previous three chapters have outlined the changing global backdrop to Australian trade and trade policy. However, as described in Chapter 1, an important feature of *global* trade has been the emergence of *regional* trading blocs. In Australia's case, the data suggest that we are part of the growing bloc centred on East Asia. In 2004, for example, more than half of all Australian merchandise exports went to the region, and roughly half of all merchandise imports were sourced from it.[164] From an Australian perspective, developments in regional trade are therefore critical determinants of the new terms of trade. Moreover, with the region an increasingly important player on the world stage, these trends also have global implications. Chapters 4 and 5 therefore look at the regional context for Australian trade policy, beginning by outlining the shifting pattern of regional trade flows.

East Asia's growing global presence

East Asia is closely integrated into the global economy, with many of the region's economies very open to international trade relative to their size, as measured by the ratio of trade to GDP (Table 4.1).[165] Indeed, a particular feature of the region is the number of so-called 'super-trading' small, open economies, which have a ratio of trade to GDP greater than 100 %. Larger economies like China and (South) Korea are also relatively open.

Table 4.1 Trade ratios for selected East Asian economies (2003)

	Trade as share of output (%)	Manufactures as share of goods exports (%)	Manufactures as share of goods imports (%)	High-tech exports as share of manufactured exports (%)
China	66	91	80	27
Hong Kong SAR	331	93	91	13
Indonesia	57	52	56	14
Japan	22	93	58	24
Korea	74	93	64	32
Malaysia	208	77	83	58
Philippines	99	90	80	74
Singapore	—	85	80	59
Thailand	125	75	76	30

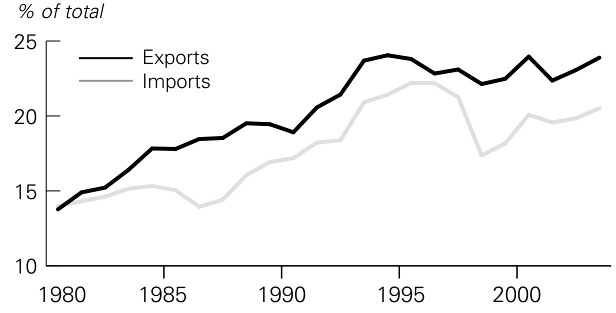
Source: Adapted from World Development Indicators online[166]

The region's evolving trade profile has been intimately linked with the growth of international trade in manufactures highlighted in Chapter 1. Regional exports (and imports) are dominated by

manufacturing products, while within that category several economies are also heavily dependent on exports of the high technology products which until the IT crash had been one of the fastest growing sub-categories of international trade.

Another global trade trend highlighted in Chapter 1 was the emergence of new trading powers, and the region has also been at the centre of this phenomenon, beginning with the (re-)emergence of Japan as a major trading nation in the 1960s and 1970s. Japan was followed by successive waves of regional economies, first the newly industrialising economies (NIEs) of Hong Kong, South Korea, Taiwan and Singapore, then the 'Tigers' of Southeast Asia (Thailand, Malaysia, Indonesia and the Philippines), and most recently by China. The regularity of the process by which the production and export of goods has in the past migrated between regional economies is sometimes described as the 'flying geese' model of regional development.[167] The basic idea here is that Japan would start off as the leading regional exporter of a given product. Then, over time, as the product became more commoditised, leading to falling prices, and as Japanese wages and other costs rose, squeezing profit margins, Japanese firms would respond to the shift in comparative advantage by using FDI to move production offshore to regional economies with lower cost structures, while at home graduating into industries further up the value chain with fatter profit margins.[168] The result has been a sort of cascade of regional integration into the global economy.

Figure 4.1
East Asia's share of world goods trade

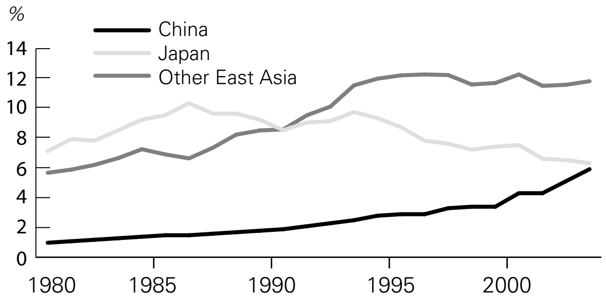


Source: Adapted from IMF Direction of Trade Statistics

One consequence of this cascade is that the region has seen a sustained rise in its share of world trade (Figure 4.1). This trend has continued into recent years, albeit marked by an interruption associated with the disruption of the 1997–98 financial crisis. According to data from the IMF's Direction of Trade Statistics, East Asia increased its share of world goods exports by about ten percentage points between 1980 (almost 14 % of the total) and 2003 (about 24 %).[169] Indeed, in 2003 the region's share in world exports reached a new peak, just passing the previous high recorded in 1995, before the onset of the financial crisis. In contrast, while the region's share in global imports rose by about six and a half percentage points over the same period, the current share is still well down on the peak of about 22 % reached in 1996, before the Asian crisis.

A second consequence of this cascading pattern of regional integration has been a series of changes in the product and especially country composition of regional trade flows. This is visible, for example, in Figure 4.2, which tracks the evolving global market share of East Asia by country and where perhaps the most striking recent development is the rise in China's share of global markets in contrast to the relative decline experienced by Japan.

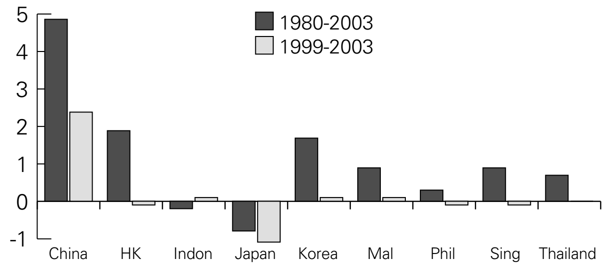
Figure 4.2
Countr shares of world goods exports



Source: Calculated from IMF Direction of Trade Statistics data

As we have seen, the arrival of new regional trading powers has been a regular event since the end of World War II. But the latest and most dramatic example of this process — China's arrival as a major actor in global export and import markets — is a more recent development. Between 1980 and 2003 China increased its share of world exports by almost five percentage points. This strong performance persisted during and particularly after the Asian crisis, with China growing its global export market share by about two percentage points between 1999 and 2003, for example. This is in contrast to most other regional economies over this period, whose market share was either flat or falling (Figure 4.3).

Figure 4.3
Change in East Asia's share of world goods exports
Percentage points



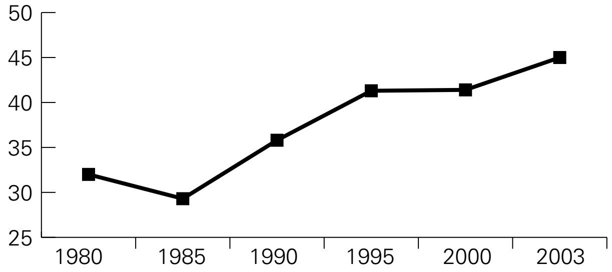
Source: Adapted from IMF Direction of Trade Statistics

This difference in relative performance is arguably the source of at least some of the concerns that have been expressed in the region about being squeezed out by a 'super-competitive' China.

Rising intra-regional trade

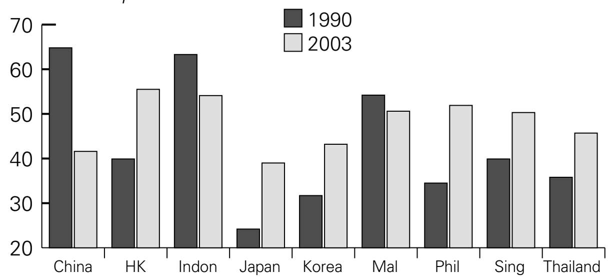
Another reason East Asia has grown its share of world trade is that the region's export markets have tended to grow faster than the average 'world' export market, in large part due to the strength of intra-regional trade.[170] The latter has grown particularly rapidly over the past decade. For example, while the share of intra-regional exports in total exports rose by less than four percentage points between 1980 and 1990, it jumped by more than nine percentage points between 1990 and 2003, a period that included the Asian crisis (Figure 4.4).

Figure 4.4
East Asian intra-regional exports
% of total e ports



Source: Adapted from IMF Direction of Trade Statistics

Figure 4.5
Intra-regional exports y countr
% of total e ports



Source: Adapted from IMF Direction of Trade Statistics

One detailed study of regional trade trends calculates that since the mid-1980s intra-regional trade in emerging East Asia has been growing at a rate roughly double that of world trade overall, a far faster pace than intra-regional trade in either NAFTA or the EU. Another study

estimates that the increase in intra-regional trade accounted for just over half of total export *growth* in emerging East Asia in 1998–2002, compared to the roughly one-third share accounted for by exports to the EU, Japan and the United States.[171] For several of the region's economies, intra-regional trade now accounts for more than 50 % of exports, although China is seeing extra-regional exports grow in importance (Figure 4.5).

Expanding regional production networks

One of the key drivers of growing intra-regional trade has been another global trend: the rise of international vertical specialisation. A large portion of the increase in East Asian intra-*regional* trade has been driven by the rapid expansion of intra-*industry* trade. On one estimate, the average share of total trade growth due to intra-industry trade growth in emerging East Asia rose from 42.5 % in 1986–90 to 75 % in 1996–2000. Much of this intra-industry trade appears to have taken the form of regional vertical specialisation (the share of exports of intermediate goods to other regional economies rose from 25 % in the late 1970s to 47 % in 2002).[172] As is true for the international economy generally, vertical specialisation in East Asia has been encouraged by the falling cost of managing cross-border production chains, itself a product of lower import tariffs, falling transport and freight charges, and reduced transit times.[173]

Francis Ng and Alexander Yeats have tracked the export and import profiles of East Asian economies over time. They construct indicators which show both that intra-regional trade in East Asia is highly 'intense', and that this intensity has increased over time.[174] They also find growing similarities between the types of goods regional economies export and import, indicating a growing complementarity among East Asian economies. By 2001, the degree of complementarity in East Asia had reached similar levels to that prevailing for the original six members at the time of the formation of the EEC.[175]

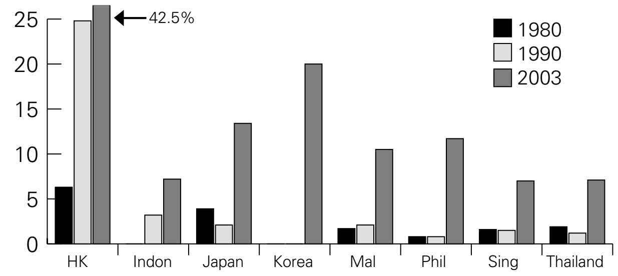
China's regional role

Another important link in the manufacturing/intra-regional trade/ vertical specialisation nexus is the growing role of China as a regional market.

Not surprisingly, the logic of geography means that China's emergence as a major global trader is having its greatest economic impact in the surrounding region. Since 1980 China's importance as an export market for the rest of the region has increased dramatically, with much of the rise coming after the mid-1990s. During 1995–2001 emerging East Asian exports to China grew at an annual average rate of 11.5 % against a growth rate of less than 4 % for world trade, leading to a rapid increase in the rest of the region's interdependence with the Chinese economy (Figure 4.6).[176]

For many economies this process accelerated after the 1997–98 financial crisis. In part, this was due to China's continued strong economic growth at a time when much of emerging East Asia was dealing with financial crisis and when Japan's economy was still in a period of relative stagnation. Trade with China was probably also given a boost by the stability provided by China's (recently loosened) exchange rate peg to the US dollar. However, it also reflected the ongoing emergence of a new regional division of labour, which involves China assuming a central role as an assembly platform for the rest of the region's economies. Thus rather than exporting directly to (say) the United States, producers in economies like Japan and South Korea now ship parts and components to China for assembly to take advantage of lower labour costs.[177] In the early stages of this process, the production relocated to China was concentrated in low-end, labour intensive industries like clothing and textiles. More recently, however, the expansion of regional production chains has been associated with China's growing competitive advantage — based on large inflows of FDI and cheap labour — in higher-end manufacturing, particularly in the electronics sector. Thus the biggest category of exports to China from its major regional trading partners in 2003 was electrical machinery (34 % of the total) followed by machinery (17 %) and chemical products (15 %).[178]

Figure 4.6
Regional exports to China
% of total e ports



Source: Adapted from IMF Direction of Trade Statistics

Meeting China's challenge

This rising importance of China to the region — in particular to the *emerging* economies of East Asia (the somewhat different case of Japan is touched on in Box 8) — has prompted two alternative economic stories. The first of these sees China and the rest of the region as 'comrades' that share mutual benefits from growing trade ties, while the second pictures them as 'competitors', producing goods that are relatively close substitutes and which therefore compete in key markets like the United States.[179]

Box 8

Japan and China: the bilateral trade relationship

While much of the focus on the implications of China's economic rise for the rest of the region has been on the economies of *emerging* East Asia, there have also been significant developments in bilateral economic relations between China and the region's leading developed economy, Japan.

The importance of China to Japan both as a source of imports and as a major export market has grown steadily over the past two decades. This is an indicator of growing economic integration between the two countries (Table 4.2). Indeed, by 2004 'greater' China (China and Hong Kong SAR) had overtaken the United States to become Japan's greatest trading partner.[180] China has also become an increasingly significant destination for Japanese overseas investment.

Table 4.2 Japan's merchandise trade with selected trading partners (% of total)

	Exports			Imports		
	1983	**1993**	**2003**	**1983**	**1993**	**2003**
Region						
China	3.3	4.8	12.1	4.0	8.5	19.7
South Korea	4.1	5.3	7.3	2.7	4.9	4.7
Hong Kong	3.6	6.3	6.3	0.5	0.8	0.4
ASEAN	10.5	13.9	12.9	15.7	14.7	15.3
A&NZ	3.6	2.5	2.5	6.0	5.8	4.5
Sub-total	**25.1**	**32.8**	**41.2**	**28.9**	**34.7**	**44.5**
Other						
US	29.5	29.5	24.8	19.6	23.2	15.6
EU	14.7	16.8	15.9	7.5	13.8	13.1
Sub-total	**44.2**	**46.3**	**40.7**	**27.1**	**37.0**	**28.7**

Source: Adapted from IMF Direction of Trade Statistics

Not surprisingly, the economic rise of China has prompted debate about whether this is a boon or threat to Japan's economic position, with pessimists pointing to the relocation of low-end industry to China as an indicator of 'hollowing out'. In recent years, booming Japanese export sales to China have encouraged a sense that the two economies should be viewed as complementary rather than competing and most economic modelling confirms the view that China's engagement in the world economy is likely to be a boon for Japan's own economic prospects. Nevertheless there remains an atmosphere of economic, as well as strategic, competition between Tokyo and Beijing.[181]

There are elements of truth in both descriptions. Thus, growing intra-regional trade provides compelling evidence in favour of the first interpretation, with China serving as a potent source of demand for the rest of East Asia. Since WTO accession in 2001 China has been by far the largest source of export market growth for many of the rest of the region's economies. In 2003 growth in exports to China and Hong Kong accounted for more than half of the overall export growth enjoyed by Korea and Taiwan, and roughly one quarter of that recorded by Malaysia and Thailand. The growing complementarity between regional economies is at work here: China now sources over 60 % of its imports of industrial high tech and transport machinery, equipment and components from emerging East Asia. And while the biggest beneficiaries of this trade in parts and components to date have been the NIEs, some of the Southeast Asian Tigers — Malaysia, the Philippines and Thailand — have also received a healthy boost to their manufactured exports.[182]

Southeast Asia's traditional exports have also benefited from China's growing demand for commodities. For example, soaring car and motorcycle sales have boosted China's demand for rubber and petroleum, which in turn has lifted exports of those commodities from Thailand and Indonesia. Similarly, growth in China's restaurant trade and processed food industry has bolstered demand for palm oil, of which Malaysia is a key supplier.[183] Indeed, some have wondered whether this resource trade means that the future for Southeast Asia lies in a return to the production structures of the 1950s and 1960s and a role predominantly as a primary product exporter.[184]

Table 4.3 China's merchandise trade with selected trading partners (% of total)

	Exports			Imports		
	1983	**1993**	**2003**	**1983**	**1993**	**2003**
Region						
Japan	20.4	17.2	13.6	25.8	22.5	18.0
South Korea	0.0	3.1	4.6	0.0	5.2	10.4
Hong Kong	26.2	24.1	17.4	8.0	10.1	2.7
ASEAN	5.3	5.8	7.1	3.2	6.1	11.5
A&NZ	0.9	1.3	1.6	3.6	2.1	2.0
Sub-total	**52.9**	**51.5**	**44.2**	**37.0**	**43.9**	**42.6**
Other						
US	7.8	18.5	21.1	12.9	10.3	8.2
EU	12.7	13.9	17.9	17.8	15.5	13.2
Sub-total	**20.4**	**32.4**	**39.0**	**30.7**	**25.8**	**21.4**

Source: Adapted from IMF Direction of Trade Statistics

On the other hand, there is also evidence that exports from China have replaced sales from other regional economies in markets like the United States, Japan and the EU.[185] Moreover, large segments of the regional manufacturing industry have effectively relocated to China in order to benefit from the low labour costs on offer. Thus, both South Korea and Taiwan have seen some of their exports displaced from third markets by Chinese products, while Taiwan has also seen China suck out investment and human capital.[186]

In other words, it is possible to find evidence for both the 'comrade' and the 'competitor' views of Chinese-regional relations in the data.

There have been several efforts to analyse whether China will be a boon or a bane to other regional economies using econometric modelling techniques. Much of this has been done in the context of predicting winners and losers from China's accession to the WTO, and tends to find that 'on balance' the industrialised and newly industrialising economies

in East Asia benefit from a greater role for China in international trade, while the results are more ambiguous for the Southeast Asian Tigers. For example, Ianchovichina, Suthiwart-Narueput and Zao estimate that both Japan and the NIEs will benefit from an improvement in their terms of trade and a rise in production and exports as China's demand for intermediate inputs and final products expands. For the ASEAN economies however, the same authors judge that while the Chinese market will represent sizeable opportunities, the similarity in export structures means that this will be offset by greater third market competition, particularly in sectors like clothing and textiles.[187]

Finally, while many of the channels of China's influence on the region work through trade flows — the impact of Chinese demand on regional exports, the growth of Chinese imports into regional markets, and third market competition — there are also investment effects at work. Many regional economies have been concerned that China's success in attracting massive inflows of FDI effectively reduces the pool available for the rest of emerging East Asia: last year, for example, China received an estimated 90 % of all FDI inflows into the region.

By boosting the rate of return to investment in China (for example by lowering the cost of production), and perhaps by lowering the risk premium, economic liberalisation in China should certainly have increased the attractiveness of China as a destination for foreign investment.[188] It is therefore possible that this increased relative attractiveness is diverting some FDI away from other economies in the region. McKibbin and Woo find some evidence in favour of the FDI diversion hypothesis in surveys by the Japan Bank for International Cooperation, which show a sharp increase in the proportion of Japanese firms identifying China as a promising location for FDI between 2000 and 2001 while at the same time indicating some decline in the relative attractiveness of ASEAN economies as an investment destination. Still, their modelling work finds that the only regional economies that could potentially be 'de-industrialised' by FDI diversion would be the ASEAN Tigers and that this would occur only in the case where FDI involves technological spillovers for the recipient economy *and* where the affected countries were slow in reversing any reduced rate of technological diffusion.[189] Moreover, other work has suggested that it is possible that China's economic success could in fact *stimulate* investment elsewhere in the region, in order, for example, to take advantage of the growing complementarity in trade profiles described earlier.[190]

Taken overall, the clear message to emerge from a review of East Asian trade trends is that China's growing influence on regional trade is a major feature of the new terms of trade.

Chapter 5

Preferential trade in East Asia

Growing East Asian 'regionalism'

The regional context for Australian trade and trade policy is being reshaped not just in terms of shifting patterns of trade, but also by a changing policy environment that includes a growing element of 'regionalism'. True, the move to increased regional integration at a policy level has lagged behind the much greater market-driven integration described in the previous chapter. But there are signs that policy integration is starting to follow where economics has led. In particular, for a region that in the past has seen relatively few efforts towards creating regional links and cooperation, the start of the current century has seen a marked increase in discussion about regional economic cooperation.[191]

The new wave of regional initiatives was initially more apparent in terms of financial than trade policy.[192] The idea of closer regional monetary and financial cooperation was given a boost by the Asian financial crisis which breathed life into 'blue-sky' ideas like an Asian Monetary Fund (an idea first raised by Japan in 1997) or a common Asian currency. But more concretely, the aftermath of the crisis also saw:

- regional central banks put in place the Chiang Mai Initiative of currency swaps;
- ASEAN establish regional surveillance procedures, along with the Asian Bond Markets Initiative; and
- the negotiation of several agreements on technical matters and information sharing.[193]

Increasingly, however, it is trade policy initiatives that are starting to make the running. In particular, the last few years have brought a plethora of new and proposed trade agreements which have at least the potential to fundamentally reshape the regional trading environment (see Table 5.1 below for a non-exhaustive list of proposed and actual agreements). This rapidly expanding web of East Asian trade agreements is another key element of the new terms of trade.

The fall of the last multilateralist standing

Chapter 3 described the recent global rush to PTAs, suggesting that in many ways it was the combination of the number and the characteristics of the recent spate of agreements (the 'third wave'), rather than preferential trade per se, that was novel. But one development that *is* new is the spread of PTAs to East Asia, which until recently had been the last major regional holdout against PTAs in their various forms. Indeed, in many ways, the region was the last pure 'multilateralist' left standing: in 2000 when according to the WTO roughly 43 % of world trade took place within PTAs, less than 6 % of East Asian trade did so (Chapter 3, Figure 3.2); for Western Europe the share was around 65 %, while North America was roughly in line with the global average, at about 41 %. As late as the mid-1990s there was still only one significant PTA operating in East Asia — the ASEAN FTA (AFTA) — which was broadly compliant with GATT Article XXIV.[194]

Table 5.1 Selected East Asian PTAs, actual and proposed

China–Hong Kong SAR	Japan–Taiwan
China–Australia	Japan–Thailand
Singapore–Australia	Hong Kong–New Zealand
Singapore–Canada	Thailand–Australia
Singapore–Chile	Thailand–Croatia
Singapore–European Free Trade Association (EFTA)	Thailand–Czech Republic
Singapore–Japan	Thailand–India
Singapore–Mexico	USA–Australia
Singapore–New Zealand	USA–Philippines
Singapore–Korea	USA–Taiwan
Singapore–Taiwan	Australia–Malaysia
Singapore–USA	New Zealand–Australia (CER)
Korea–Australia	AFTA
Korea–China	ASEAN + CER
Korea–Chile	ASEAN + China (ACFTA)
Korea–Japan	ASEAN + India
Korea–Mexico	ASEAN + Japan
Korea–New Zealand	ASEAN + Korea
Korea–Thailand	Singapore + EFTA
Korea–USA	ASEAN + 3
Japan–Canada	ASEAN + EU
Japan–Chile	Japan–Korea–China
Japan–Malaysia	Pacific 5[195]
Japan–Mexico	
Japan–Philippines	

Sources: Adapted from Table 3.1 in Pangestu and Gooptu (2004) and various media reports

The region's past reluctance to follow the preferential trade route reflected a combination of economic and political factors. A large part of the economic explanation rests on the high degree of economic integration with the rest of the international economy, as a consequence of which *inter*-regional trade and investment flows have historically tended to dominate *intra*-regional ones. Hence it has been natural for the region's economies to look outwards and to the multilateral system. Together with the fact that regional economies tend to be more open (in the sense of higher ratios of trade to GDP) than either the EU or NAFTA, this may have made them relatively more invested in a healthy *global* trading system.[196]

Politically, a lack of strong, central leadership from within the region comparable to the role played by France and Germany within the EU may also have hampered region-wide initiatives, a factor that reflects long-standing historical animosities between the major trading powers of Northeast Asia. Japan's apparent reluctance to pursue regional initiatives that would run counter to the interests of its US ally has also been a limiting factor, along with regional reservations about Tokyo's leadership.

Finally, the impetus for regionalism may also have been constrained by the significant level of regional diversity in terms of culture, language and level of economic development.[197]

Towards a 'noodle soup' of regional PTAs?

East Asia's opinion on PTAs started to turn at the end of the last century. The Auckland APEC economic leaders meetings in September 1999 saw proposals or studies for several PTAs announced, including the Singapore–Japan, Singapore–Chile, Singapore–New Zealand, South Korea–Chile and Japan–Mexico agreements. More followed at the November 2000 meeting, with announcements including the Singapore–US and Australia–Singapore deals.[198] At the same time, Beijing proposed an FTA between China and ASEAN, a move swiftly followed by news of a planned Japan–ASEAN agreement.

The landmark change in the region came in Northeast Asia when the dominant regional trading powers of Japan, South Korea and China abandoned their long-standing policy of pursuing only multilaterally-

based trade liberalisation.[199] The signature in 2002 of the Japan–Singapore Economic Partnership Agreement marked the first time that one of these big three trading powers had signed a PTA. Southeast Asia's conversion to the PTA route had arrived earlier, led by Singapore's plan to turn the island state into a hub for regional trade.

This is not to say the region has abandoned multilateralism. The accessions of China (2001) and Taiwan (2002) to the WTO are evidence of East Asia's continued attachment to dealing with trade at a global level, and Cambodia's even more recent WTO accession in November 2004 signals that regional economies continue to see membership in the multilateral system as worthwhile. Still, the undeniable fact is that, for now at least, East Asia is firmly set on the PTA route. Indeed, the region seems to be in the process of generating its own complex, overlapping network of trade agreements that match the spaghetti bowl at the global level; a 'noodle soup' of discriminatory deals.[200] The list of proposed and actual agreements in Table 5.1 highlights the way in which virtually every significant trading economy in the region is now either already a member of one or more agreements, or is actively pursuing membership. The number of regional PTAs in prospect is multiplying rapidly, and some of them are potentially very significant. For example, the ASEAN–China (ACFTA) agreement creates the world's largest PTA by population, covering 1.7 billion people and a GDP of around US$2 trillion.[201]

Joining the PTA bandwagon

Why have regional policymakers decided to jump on board the global PTA bandwagon? In part, growing regional interest in PTAs may just be a natural side-effect of the 'deeper integration' associated with rising intra-regional trade.[202] However, international specialisation also led to rapid growth in intra-regional trade during the 1990s, *before* the current spurt in PTAs, so other forces have been at work.[203]

An important early factor was the end of the Cold War, which facilitated the expansion of ASEAN and the creation of APEC. But a more recent catalyst for greater efforts towards regional policy initiatives in general was the way in which the 1997–98 Asian financial crisis created a renewed awareness of economic interdependence, and encouraged regional policymakers to think about greater policy-led integration as a mechanism for reducing economic vulnerability. The crisis may also have led to a sense of 'them and us', with a belief that the region did not get a fair shake from a Western-dominated IMF during the crisis. In particular, Indonesia's experience with the Fund led at least some regional policymakers to draw the lesson that reliance on agencies external to the region involved a significant risk of conflicting economic and political agendas. Greater regional cooperation was seen as one way of reducing dependence on the IMF and hence the risk of having policies 'dictated' by outside interests. A related development here may be what Rawdon Dalrymple has described as 'an increasingly influential sense of shared 'Asianness' in the region'.[204]

Greater regional interest in PTAs is probably in part a defensive response to the proliferation of PTAs outside the region and the associated risk of trade and investment diversion. The continued expansion of the EU, together with the possibility of a Free Trade Area of the Americas (FTAA), has helped encourage the consideration of an equivalent regional bloc in Asia, while at the same time the successes of the EU and NAFTA have also had *positive* demonstration effects. The 'domino effect' discussed in Chapter 3 has been at work.[205]

Regional policymakers have also worried about the direction of trade policy in the major extra-regional trading partners, with some pointing to fears of growing US protectionist sentiment and a concern that the EU no longer has much enthusiasm for pushing ahead with further trade liberalisation and reform.[206]

Finally, two other region-specific factors appear to have played an important role in promoting PTAs: disappointment with APEC and the need to manage China's rise.[207]

Reacting to APEC's faded promise

The region's growing interest in PTAs may have been spurred by the relative failure of the alternatives on offer. Chapter 2 described some

of the challenges facing the multilateral system and it seems likely that this produced disillusion at the regional as well as the global level. However, many of the regional PTA initiatives came before the failure of the Seattle Ministerial Meeting in December 1999, and may have been motivated as much or more by disappointment with the prospects for APEC-led trade liberalisation as by problems with the WTO.[208]

APEC was established in 1989 to enhance regional cooperation and promote trade and investment. One of its original motivations was to provide a regional forum for trade initiatives less compromised by the geographical exclusivity of initiatives such as the European single market or NAFTA. In particular, by combining members from both the Americas and East Asia, it was explicitly designed to avoid 'drawing a line down the middle of the Pacific' — a risk in the event of the formation of an East Asian only bloc — but instead to capture the important role played by trans-Pacific trade.[209] Arguably the highpoint of this initiative came in 1994 with the Bogor declaration. This committed APEC member economies to 'free and open' trade and investment within the region by 2010 for developed economies and by 2020 for developing ones.[210] In a process designed to be both WTO-consistent and sympathetic to APEC's consensual approach, members were to submit Individual Action Plans (IAPs) which would comprise voluntary and non-binding commitments to move towards the Bogor goals, and which would be supplemented by Collective Action Plans setting out joint work programs on business facilitation measures such as standardisation of customs procedures.

In practice, most IAPs failed to go much beyond what members would have done anyway, either in the context of commitments made under the Uruguay Round or under unilateral initiatives. Disappointment with IAPs led APEC to consider a process of 'early voluntary sectoral liberalisation' (EVSL), under which specific sectors would be targeted for liberalisation. But members failed to reach a consensus on which sectors should be included, with Japan in particular refusing to open sensitive sectors such as forestry and fishing. With the EVSL process a failure, and with IAPs a disappointment, it became increasingly apparent that APEC would deliver little more in terms of *additional* trade liberalisation. Instead, and somewhat ironically, APEC meetings increasingly became a venue at which to propose or announce PTA initiatives that ran directly counter to the organisation's early emphasis on open regionalism.[211]

This process has culminated in what appears to be a 'if you can't beat them, join them' view of PTAs. Thus at the November 2004 APEC Leaders Meeting, the Santiago declaration stated that leaders 'agreed that [PTAs] play a constructive role in accelerating liberalization in the region, thus contributing to the achievement of the Bogor Goals and advancing the WTO process'.[212]

Managing China's rise

The region's conversion to PTAs has also been triggered by the growing economic weight of China. From the point of view of the economies of emerging East Asia — particularly the members of ASEAN — PTAs seem to offer a mechanism for managing economic relations with an increasingly important neighbour by institutionalising cooperation in trade policy.[213] Similarly, from Beijing's perspective, PTAs offer a means to soothe nervous regional trading partners: arguably one of the motives for China proposing an FTA with ASEAN was to assuage the kind of Southeast Asian fears about Chinese competition in third markets and for FDI discussed in Chapter 4.[214]

PTAs also offer Beijing a tool of economic diplomacy which at least in theory it can wield to strengthen its influence on neighbouring economies and exert regional leadership. Indeed, China's economic diplomacy in this regard is sometimes seen by external observers as part of a grander strategy that in the longer term 'could see the recreation of the kind of strategic centrality that China enjoyed at the height of imperial rule, when Asian states paid tribute to Beijing and recognized its pre-eminence in return for favourable terms of trade'.[215] In this view, these agreements are not just — or even primarily — about trade, but rather serve to establish regional influence and leadership.

Certainly, the emergence of a network of trade agreements with China at the centre could be seen as a parallel development to the

way in which other major powers in the international trading system (the United States with NAFTA and the FTAA and the EU with its accession and other agreements) have sought to combine multilateral trade diplomacy with supplemental regional agreements dealing with interests in markets 'closer to home' in ways that go beyond the WTO and that provide benefits to the larger country that reflect the asymmetry in the power relationship involved.[216]

To the extent that PTA formation *does* have a geo-strategic component, it will trigger responses from other would-be regional leaders. Thus in the same week that ASEAN and China declared that they would pursue a trade agreement, Japan issued an ASEAN–Japan Joint Declaration on Comprehensive Economic Partnership, a move that was widely interpreted as an act of competition with China for influence in ASEAN. Indeed, ASEAN itself seems inclined to play a balancing game of sorts: on the same day as the Japan–ASEAN declaration, India also agreed to establish a PTA with ASEAN.[217]

Towards an East Asian trade bloc?

So what does the spread of PTAs mean for the regional trading environment? One response to this question is 'perhaps not very much'. It's possible that the current swathe of agreements will turn out to be more about sending political signals and delivering the diplomatic equivalent of public relations events than about economic substance.

Past experience does suggest reasons to be sceptical about just how much some of these agreements will deliver. After all, at this stage many are little more than expressions of intent. Even some of the more concrete agreements — for example the ASEAN–China agreement, which was due to go into effect in July 2005 and at the time of writing was already producing tariff cuts as part of an early harvest program — at this stage still looks quite far from delivering a truly 'comprehensive' trade deal. For example, it includes a list of so-called 'sensitive' and 'highly sensitive items' (of which there are many) which will only see relatively modest tariff reductions get under way late in the process.[218] A look at AFTA — the principal regional PTA in operation before the recent flurry of activity — also provides grounds for scepticism (see Box 9). So one possibility is that the region's 'noodle soup' of trade agreements amounts to little in practice, with few implications other than for the waste of negotiating resources.[219] However, it is also possible that the current wave of agreements will accumulate substance over time, and so turn out to be a much more significant influence on regional trade flows than the experience with AFTA might suggest.

Box 9

Lessons from AFTA

The ASEAN Free Trade Area (AFTA) is East Asia's only longstanding PTA and dates from a 1992 agreement. AFTA went into effect for the six original members of ASEAN (Brunei, Indonesia, Malaysia, the Philippines, Singapore and Thailand) on 1 January 2002, with the agreement calling for a reduction on manufactured tariffs to a 0–5% range, and for the six original members to bring tariffs down to zero by 2010.[220]

As a benchmark for future trade agreements, AFTA offers mixed evidence. On the one hand, it is a reasonably 'clean' agreement, broadly in line with the GATT guidelines on PTAs and with reasonably liberal rules of origin. Yet in other ways it has been a disappointment. Backsliding on commitments to cut tariffs has been common, as have exemptions. Several members have either refused to lower tariffs on critical products (for example, Malaysia has sought to protect its state-owned carmaker), or at times have reversed earlier tariff cuts (the Philippines first reduced, and then increased tariffs on petrochemicals). Rice, the region's biggest crop, was excluded from the initial agreement altogether.[221]

There is little evidence that AFTA has significantly boosted intra-regional trade. This is not surprising as roughly two-

thirds of tariff lines within the region have the same MFN and preferential tariff rates, while the remaining one-third have relatively little difference between MFN and preferential rates. Given AFTA's rule of origin, requiring 40% ASEAN content, it is possible that the modest difference in tariff rates is not worth any change in production arrangements necessary to meet content requirements. As a result, it has been estimated that less than 5% of intra-regional trade takes place under the preferential tariff.[222] AFTA has also been criticised for the way in which its members have been slow to draw up shared procedures and standards for imports, even though the World Bank has identified such non-tariff barriers as one of the biggest drags on regional trade.[223] Indeed, disappointment with the slow pace of progress under ASEAN/AFTA has been cited by Singapore as a reason for that country's pursuit of bilateral trade agreements outside the framework of AFTA, with policymakers highlighting a 'convoy problem', whereby the pace of trade integration has been held back by the pace of the slowest economies.[224]

AFTA's shortcomings have prompted some commentators to speculate that future PTAs such as the ASEAN–China FTA will suffer from similar failings, given their basis will be AFTA itself.[225]

Given the recent nature of the regional swing to PTAs, most assessments of their likely consequences are *ex ante* economic modelling exercises, along the lines described in Chapter 3. As highlighted earlier, the results of these models are highly sensitive to the various assumptions made. Nevertheless, they do generate some fairly consistent findings:

- to get significant trade effects, regional PTAs need to include one of the major trading powers in the region;
- members of regional PTAs tend to benefit from positive welfare and net trade-creating effects;

- the impact on non-members is negative and increasing with the membership size of the PTA; and
- multilateral MFN liberalisation delivers significantly bigger global welfare gains than preferential liberalisation.[226]

For example, Scollay and Gilbert estimate that a Japan–South Korea–China PTA would produce welfare gains for the three members, but significant losses for the rest of the West Pacific, especially ASEAN and Taiwan. The conversion of such an agreement to an ASEAN + 3 arrangement by linking in AFTA would then see welfare losses for Southeast Asia replaced by welfare gains, while the losses for those regional economies still excluded (Taiwan, Australia, New Zealand) would become even larger. Extending membership again to include Australia and New Zealand would boost members' welfare once more while imposing still larger losses on excluded economies, including the United States. These sorts of results point to something like Baldwin's domino hypothesis at work, with strong economic incentives for expanding PTA membership (via rising welfare for existing members and converting welfare losses into gains for previously excluded economies), but at the cost of rising losses to excluded regional economies.[227]

Living in a tri-polar world

Writing in *The Economist* magazine at the start of the current century, Fred Bergsten argued that the emergence of new regional systems in Asia would eventually lead to a world economy shaped by a 'three-block configuration' of the United States, the EU and East Asia.[228] The economic modelling results outlined above do suggest the presence of a strong motive for regional trade agreements in East Asia: if regional PTAs continue to proliferate, the *economic* logic at least — mounting gains from expanding membership, mounting losses from exclusion — points to an end-game that will bring about a region-wide trade bloc.

But a key question is 'To what extent will economics drive the process, as opposed to factors such as regional politics or security issues?' The motivation that dominates could mean the difference

between a comprehensive East Asian trade bloc and a region splintered into several competing ones. In particular, the formation of a genuine regional trade bloc would require the cooperation of all three of the trade heavyweights in Northeast Asia; a move which clearly faces significant obstacles. Indeed, such are the economic, political and security dilemmas involved that many observers have concluded that a region-wide bloc has little chance of becoming a reality.[229] Still, the economics at least suggest that *if* these obstacles were overcome, the outcome could well be a domino effect leading to an East Asian trading bloc.

What would this mean for the global trading environment? Given the prospect of a Free Trade Area of the Americas (FTAA) across the Pacific, and the fact that a European trade bloc is in existence already, one consequence would be the emergence of a formal tri-polar trading world that would map onto the three effective regional trading blocs identified in Chapter 1, marrying policy with trade flows. We are hard pressed to know beforehand what such a development would mean for the world economy (see Chapter 3). While some economic models suggest that a three-bloc world would be the worst possible outcome for global trade, these results are sensitive to underlying assumptions. Provided the three blocs each remained committed to an open trading system, trade policy issues might actually be easier to manage than in a setup comprising a whole series of small-scale PTAs. However, we cannot ignore the bulk of model simulations which suggest that a major East Asian trade bloc would have adverse consequences for non-members like the United States or the EU. Such a grouping could clearly be a source of global trade tensions.

A final complication is the potential geopolitical implications of a regional trade bloc. It is notable that back in the early 1990s, when Malaysian Prime Minister Mahathir was pushing for what would in effect be an Asians-only regional grouping, the United States felt the need to exercise an effective veto on the initiative. Yet the same sort of initiative — in the form of the East Asian Summit (EAS) — is now firmly back on the agenda. Furthermore, trade policy is arguably an increasingly important building block for these regional initiatives. There is some concern that it could become an instrument for regional power plays: on one interpretation, for example, China's trade agreements give Beijing a way to signal the high economic cost for regional economies involved in antagonising China.[230] If trade policy does become more linked to such strategic gambits, presumably it would entail countervailing responses from other major players inside and outside the region, adding yet another complicating factor to the new terms of trade facing policymakers.

Part III

The Australian context

Chapter 6

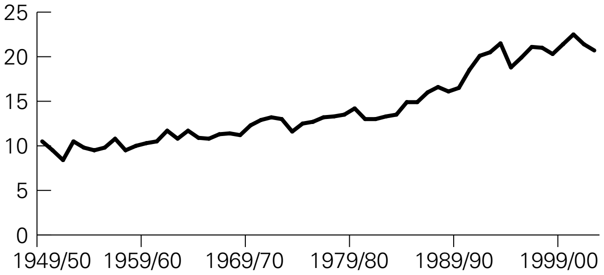
Australian trade and trade policy in transition

The previous chapters have described some of the changes in the international and regional trading environments within which Australia operates. Here we focus on the Australian context, beginning with a quick look at the extent to which these external developments have been paralleled by changes in Australia's trade profile and trade policies.

Growing international integration

Chapter 1 began by suggesting that one important feature of the new terms of trade is the increasing share of international trade in world output (Figure 1.1). The same type of measurement confirms that Australia has also become a more open economy, in line with the global trend. Figure 6.1 charts the ratio of exports of goods and services to GDP since 1949/50, revealing a fairly steady rise in openness, particularly after Australia started to reduce trade barriers in the 1970s and moved to a floating exchange rate in 1983.[231]

Figure 6.1
Australian economic openness over time
E ports of goods and services as % of GDP



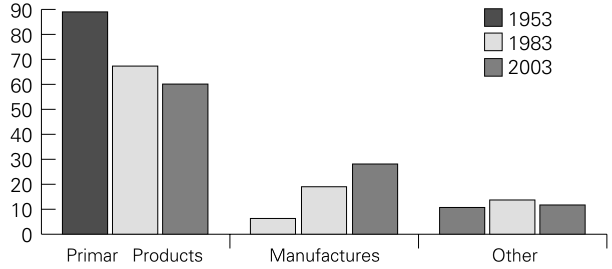
Source: Adapted from Reserve Bank of Australia (RBA) and Australian Bureau of Statistics (ABS) weysites

A cross-country comparison gives a slightly different message, with Australia's share of trade in GDP relatively low compared to many other developed economies. However, Australia's level of openness is not surprising once fundamental factors such as its population, stage of economic development, and geographic size and location are taken into account. In particular, a lower level of openness compared to its peers is largely explained by Australia's relative remoteness from other major trading partners and its larger land mass.[232]

A changing trade structure

Another global trend apparent in the Australian data is a shift in the composition of trade. Traditionally, Australia has been a major commodities exporter and a substantial importer of manufactures, effectively relying on the sale of rural and mineral resources to pay for manufactured goods. While this description continues to capture a big part of the story, there have nevertheless been significant compositional shifts in Australia's export profile that have tracked the rise in importance of trade in manufactures and services seen at a global level. Thus the share of primary products (energy and minerals) has fallen from almost 90 % of merchandise exports in the 1950s to about 60 % by 2003 while the share of manufactures rose from 6 % to 28 % (Figure 6.2).

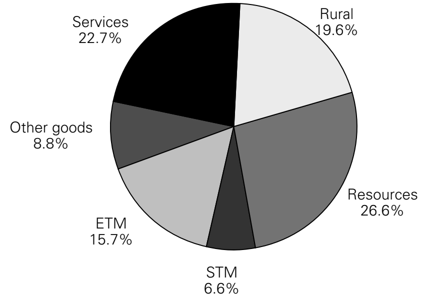
Figure 6.2
Composition of Australian merchandise exports
Share of total, %



Source: Adapted from ABS and RBA weysites

The nature of Australian manufactured exports has also changed. In the 1950s they virtually all comprised so-called simply transformed manufactures (STMs), basically metals. By 2004 roughly two-thirds of manufactured exports comprised elaborately transformed manufactures (ETMs) such as mechanical and electrical equipment along with scientific and medical equipment.

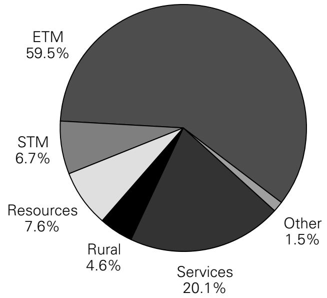
Figure 6.3
Composition of exports, 2004



Source: Adapted from Department of Foreign Affairs and Trade, Monthl Trade Statistics (Feyruar 2005)

The change in the composition of Australian exports is more visible when we look at total exports of goods *and* services. Between 1981 and 2001 exports of services and manufactures rose from 27 % of total exports to 40 %, and by 2004 the two categories accounted for almost 45 % of the total. In the same year resource exports accounted for a bit over one-quarter of total exports, while rural exports comprised almost one-fifth (Figure 6.3).

Figure 6.4
Composition of imports, 2004



Source: Department of Foreign Affairs and Trade, Monthl Trade Statistics (Feyruar 2005)

As described in Chapter 1, a significant feature of the new terms of trade is the role played by investment. By the end of 2004, Australian investment overseas stood at about A$591 billion, while foreign investment in Australia totalled around A$1,139 billion.

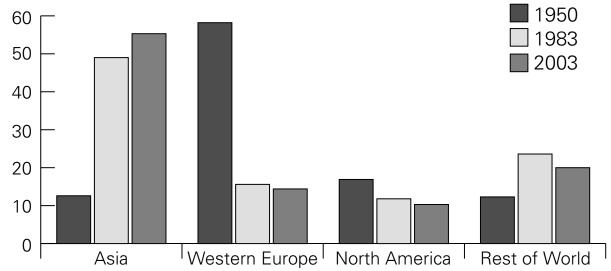
The same chapter also highlighted the role of foreign affiliates. The ABS has estimated that in 2002–03 Australian enterprises had 4012 foreign affiliates (offshore subsidiaries, branches and majority-owned foreign joint ventures) employing 321,924 staff. These affiliates generated sales revenue of A$142.3 billion, or almost as much as the A$148.5 billion of goods and services exports generated by domestically-based enterprises in the same year. Of the total sales revenue by foreign affiliates, some A$59.4 billion comprised sales of services. So for example, in terms of the four modes of service provision discussed in Chapter 1, roughly 65 % of Australian exports of services were through mode 3 — commercial presence — and therefore not captured in standard (balance of payments based) trade data.[233]

Changing trade partners

There have also been substantial changes in the direction of Australian trade. Back in 1950/51, for example, the UK *alone* was the destination for roughly one-third of Australian exports. By the start of the new millennium, the UK's share of Australian exports had fallen to a little less than 4 %.

The big medium-term trend in Australian trade has been the rise in the relative importance of Asia as a trading partner (Figure 6.5) with Japan playing a central role in this process. In 1950/51 Japan was the destination for just 6 % of Australian exports; by 1980/81 that share had risen to almost 28 %, before falling back to a little under 20 % by 2000/01. The more recent component of this change is the rise in the importance of China as a bilateral trading partner, followed even more recently by a surge in Australian exports to India.

Figure 6.5
Direction of Australian merchandise exports
Share of total, %

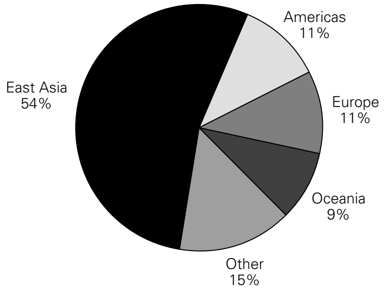


Source: Department of Foreign Affairs and Trade, One hundred ears of Australian trade

As noted in Chapter 4, developments in East Asia are now a critical element of Australia's trade environment. A look at the destination of Australian merchandise exports and the source of merchandise imports confirms this. By 2004 roughly 54 % of Australian exports went to the region, compared to 11 % each for Europe and the Americas. East Asia also dominated Australia's goods imports, accounting for 49 %

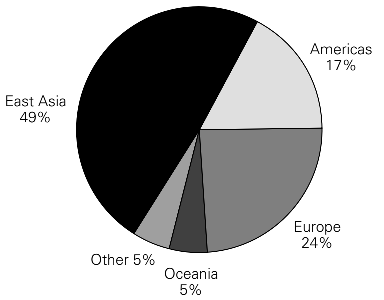
of the total, compared to 24 % for Europe and 17 % for the Americas (Figure 6.7).

Figure 6.6
Direction of exports, 2004



Source: Adapted from Department of Foreign Affairs and Trade, Monthl Trade Statistics (Feyruar 2005)

Figure 6.7
Direction of imports, 2004

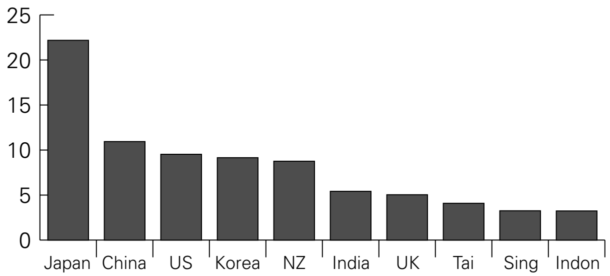


Source: Adapted from Department of Foreign Affairs and Trade, Monthl Trade Statistics (Feyruar 2005)

Indeed, of Australia's top ten merchandise export markets in 2004, six were in East Asia, accounting for 45 % of total exports. The three largest regional markets — Japan (19 %), China (9 %) and Korea (8 %) — between them accounted for about 36 % of total exports (Figure 6.8). India, another emerging Asian trading power, has moved into sixth

place in the export rankings (after export growth of more than 60 % in 2003) and in 2004 was Australia's 13th largest merchandise trading partner. Finally, note that including services trade would change this picture somewhat, for example by increasing the relative importance of the US, Singapore and New Zealand and lowering that of Korea, Taiwan and China.[234]

Figure 6.8
Top ten Australian merchandise export markets, 2004
A$ billions

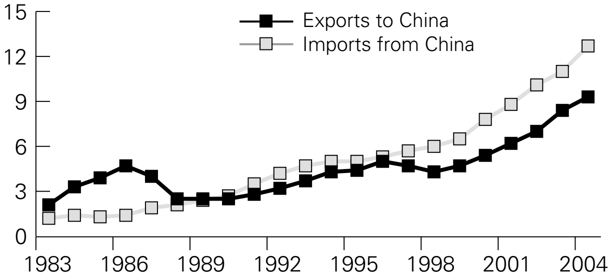


Source: Department of Foreign Affairs and Trade, Monthl Trade Statistics (Feyruar 2005)

The most dramatic trend visible in the direction of trade data is the growing significance of China (Figure 6.9). While Japan remains by far the most important destination for Australian merchandise exports, China has rapidly become a major buyer, overtaking the United States to become Australia's second largest export market in 2004. China was also the second largest source of merchandise imports in the same year and Australia's third largest trading partner overall. As for the global economy generally, the rise of China as a great trading power is one of the most significant features of the new terms of trade.

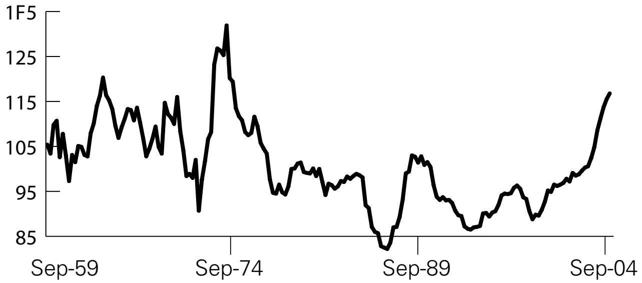
The influence of China is visible not just in the share of Australian exports and imports. We noted earlier that one impact of China on the international economy was to influence relative prices. This trend is visible in the ratio of Australian export to import prices which are now at their highest level for 30 years, thanks in large part to the upward pressure on resource prices driven by Chinese demand (Figure 6.10).[235]

Figure 6.9
Australian merchandise trade with China
% of total



Source: Adapted from Department of Foreign Affairs and Trade (2004) and Department of Foreign Affairs and Trade (2005)

Figure 6.10
Australia's terms of trade
Inde , 2002/03=x00



Source: Adapted from the RBA weysite

Trade policy evolution or devolution: from PTAs and back again?

These changes in the structure of trade flows have been accompanied by changes in Australian trade policy and here too developments have been influenced by the trends visible at the global and regional levels — specifically, the worldwide move to preferential trade.

Before the recent push to negotiate PTAs, Australia last engaged in a trade policy based on preferences in a significant way in the 1930s when, along with much of the rest of the world, it was part of the fragmentation of international trade described in Chapter 2. When the United States imposed the Smoot-Hawley tariff hike in 1930, an already protectionist-minded Australia was quick to respond with trade restrictions of its own, and after Britain abandoned free trade in 1931, the way was open for the creation of a PTA based around imperial preference, an arrangement given form by the Ottawa Agreement of 1932. Australia continued down this path in the late 1930s with the implementation in 1936 of a policy of 'trade diversion' which aimed to restrict imports from Japan and the United States in order to benefit Australian and British producers (although the retaliation provoked by this policy — including the withdrawal by the United States of MFN status — prompted a fairly swift rethink).[236]

After World War II, Australia participated in the reconstruction of the global trading system, becoming one of the 23 founding members of the GATT in 1948. Despite being one of the original signatories, however, in many ways 'Australia was not a willing convert to multilateralism'.[237] Instead, Canberra's initial instincts in the period following World War II were to prefer a strategy of relying on imperial preference and industrial protection.[238] Arguably, it was only in 1956, with the start of the retreat from imperial preference that Australia became fully committed to the multilateral trading system and turned its back on preferential trade. Even then, Australia entered into the Australia–New Zealand Closer Economic Relations Trade Agreement (ANZCERTA or the CER) in 1983.[239]

This commitment to multilateralism was subsequently wedded to efforts at unilateral trade liberalisation, particularly after trade policy underwent what Ross Garnaut has described as a paradigm shift in 1983. At that time the Hawke government adopted a trade policy regime that sought to combine the benefits of unilateral trade liberalisation and domestic reform with participation in multilateral trade negotiations and regional and bilateral liberalisation on an MFN basis.[240] Thus, 1983 brought the floating of the dollar, while 1986 saw the establishment of the Cairns Group of agricultural exporters which played a role during the Uruguay Round. Domestically, tentative efforts at tariff reform that had begun during the 1970s were extended and accelerated, and a series of tariff reductions implemented between 1988 and 1991 liberalised trade flows for most of the manufacturing sector. By the end of 2004 Australia had very low tariff protection across most sectors, with the main exceptions being textiles clothing and footwear (TCF) and passenger motor vehicles (PMV).[241] These policy changes were followed by strong export growth and a marked improvement in Australia's relative economic performance: for example, the average rate of growth of export volumes in the 1990s was the fastest of any post-war decade.[242]

Rethinking trade policy

With the exception of the CER agreement with New Zealand and its predecessors, Australian trade policy between 1956 and 1996 basically refrained from preferential arrangements, instead sticking to the policy framework provided by the multilateral system and augmenting this either with efforts at non-discriminatory regionalism or unilateral liberalisation.[243] This period of Australian trade policy ended in 1996 with the election of a Howard government committed to a more 'aggressive' and 'results-oriented' trade policy.[244]

The new approach was set out in the 1997 White Paper on Foreign and Trade Policy, which stated that '[e]xisting bilateral and multilateral approaches to trade policy … have served Australia well. For the future, however, Australia will keep an open mind about new approaches, including preferential free trade arrangements.' The White Paper went

on to serve notice that PTAs would not just be about trade policy, but would also link into foreign policy issues more generally. Thus '[i]n considering any preferential free trade arrangement … the choices for Australia are not and would not simply be ones of economic calculus. They would also raise significant foreign and strategic policy issues.' In a nod to the concerns about the effect on the multilateral system implied by the spread of discriminatory agreements, the White Paper also promised that the government would work to promote stricter multilateral disciplines on PTAs, while recognising that its ability to do so was likely to be 'limited'.[245]

By the time of the publication of the 2003 White Paper, negotiations on several PTAs were already under way and the case for preferential trade was being made in more detail, with some of the positive arguments outlined in Chapter 3 given an outing. Thus the Paper noted for example that 'progress in the Doha Round and the implementation of its results could be slow' and that a pragmatic pursuit of PTAs could deliver gains faster than the multilateral process and at the same time give an opportunity to go 'deeper and further than the WTO'. And, in an echo of an insurance policy case for participating in PTAs, it pointed out that '[i]naction as others negotiate … could risk an erosion of our competitive position in those markets'.[246]

Joining the PTA bandwagon

The agenda set out in these two White Papers is now well under way and Canberra has clearly joined the international PTA bandwagon (Table 6.1). Since the change of policy signalled in the 1997 White Paper, Australia has completed negotiations with Singapore, Thailand and the United States, and all three PTAs have now entered into effect. In addition, negotiations are already under way on an agreement with United Arab Emirates (UAE), on an ASEAN–CER deal, and on deals with China and Malaysia. Canberra and Japan have also agreed to launch a feasibility study into a bilateral PTA.

Table 6.1 Recent and prospective Australian PTAs

Agreement	Date announced	Start of negotiations	End of negotiations	Date signed	Date entered into force
Singapore–Australia Free Trade Agreement	Nov 2000	April 2001	Oct 2002	Feb 2003	July 2003
United States (AUSFTA)	Nov 2002	March 2003	Feb 2004	May 2004	Jan 2005
Thailand–Australia Free Trade Agreement	May 2002	Aug 2002	Oct 2003	July 2004	Jan 2005
China	Oct 2003	May 2005	—	—	—
Malaysia	July 2004	May 2005	—	—	—
ASEAN–CER	Nov 2004	Feb 2005	—	—	—
Australia–UAE	March 2005	March 2005	—	—	—

Source: Adapted from Department of Foreign Affairs and Trade website

Of the agreements actually signed to date, the deal with the United States (AUSFTA) has undoubtedly been the most significant, involving the most important trading partner: in 2004 the United States was Australia's third largest merchandise export market, and its largest source of imports, and its second largest trading partner overall (Table 6.2). Moreover, the United States was also Australia's most important partner in services trade (Table 6.3), as well as both the largest source of foreign investment into Australia and the biggest destination for Australian investment overseas (Table 6.4).

Table 6.2 Merchandise trade with current and planned PTA partners (2004)

Country	Australian exports (A$m)	% of total exports	Australian imports (A$m)	% of total imports	Total trade (A$ m)	% of total trade (rank)
New Zealand	8,755	7.4	5,193	3.7	13,948	5.4 (5)
Singapore	3,256	2.8	6,207	4.4	9,463	3.7 (8)
United States	9,533	8.1	20,525	14.5	30,059	11.6 (2)
Thailand	3,053	2.6	3,775	2.7	6,828	2.6 (12)
China	10,942	9.3	17,923	12.7	28,865	11.2 (3)
Malaysia	2,249	2.1	5,560	3.9	7,989	3.1 (9)
UAE	1,294	1.1	951	0.7	2,245	0.9 (23)
ASEAN–10	13,742	11.7	23,145	16.4	36,887	14.3 (—)

Source: Department of Foreign Affairs and Trade Monthly Trade Statistics and country fact sheets

In terms of *prospective* agreements, deals with China (Australia's third largest trading partner in 2004, and its second largest export market and source of imports) and ASEAN would potentially cover the most merchandise trade, and on a collective basis ASEAN is also a major partner in services trade (although much of this is already covered under the Singapore agreement).

Table 6.3 Services trade with current and planned PTA partners (2004)

Country	Australian exports (A$m)	% of total	Australian imports (A$m)	% of total
New Zealand	2,569	7.5	1,759	5.0
Singapore	2,346	6.8	2,610	7.3
United States	4,473	13.1	6,152	17.4
Thailand	488	1.4	914	2.5
China	1,269	3.7	995	2.8
Malaysia	952	2.8	726	2.1
UAE	472	1.4	1,016	2.9
ASEAN–10	5,153	15.0	5,506	15.5

Source: Adapted from Department of Foreign Affairs and Trade Monthly Trade Statistics and country fact sheets

Table 6.4 Investment with selected current and planned PTA partners (2003)

Country	Australian investment (A$m)	% of total	Investment in Australia (A$m)	% of total
New Zealand	37,088	7.3	19,648	2.0
Singapore	11,896	2.3	22,131	2.3
United States	211,004	41.5	297,311	30.4
Thailand	480	0.1	161	—
China	1,040	0.2	2,855	0.3
Malaysia	485	0.1	6,179	0.6
Sub-total	261,993	51.5	348,285	35.6

Source: Adapted from ABS, International investment position, supplementary country statistics, catalogue number 5352.0, Canberra, 2003

Debating the policy change

Although AUSFTA was neither the first PTA announced under the new strategy, nor the first to be negotiated, it was certainly the biggest and most controversial. Not surprisingly, therefore, AUSFTA triggered a major policy debate: many of Australia's leading trade policy specialists felt that giving it the go-ahead would confirm a major change in the direction of Australian trade policy.[247]

Much of the serious discussion over AUSFTA involved two distinct but closely related issues: the risks to the international trading system posed by Australia adding to the proliferation of PTAs, and the relative merits of AUSFTA itself.[248] Thus one criticism of AUSFTA was that by signing up to new bilateral and regional agreements, Australia would not only add momentum to the *global* PTA bandwagon, but would also provide added legitimacy to the spread of preferential trade in the East Asian region, with deleterious consequences for international trade. In this view, Australia would have done better to stand aside from PTAs and concentrate its efforts on reinvigorating the WTO process. In contrast, supporters of government policy argued either that bilateral and regional arrangements were complementary to an already very sluggish multilateral process, or emphasised the risks involved in remaining outside the worldwide trend to PTAs (the government itself tended to emphasise the more positive of these arguments).

Back in Chapter 3 we concluded that as yet there was no definitive answer to the question of whether PTAs were 'building blocks' or 'stumbling blocks' to freer international trade. Given this ambiguity, the first part of the Australian debate can be boiled down to a simpler question about the extent to which Canberra can shape the international and regional trade policy environment. Advocates of a trade policy that included PTAs would argue that the growth in preferential trade will continue regardless of what Australia does, so policymakers should take the new environment as an externally given constraint and act accordingly. In effect, Australia is involved in a prisoner's dilemma type game, and while the best possible strategy would be for all the players to coordinate on multilateral trade and eschew the PTA option, the reality is that individual countries will continue to participate in PTAs and under such circumstances the rational policy choice for Australia is to do the same.[249] Opponents reckon that this view of the world is unduly pessimistic about Australia's ability to influence trade policy elsewhere: Ross Garnaut has characterised this type of argument as the 'Theory of the Unimportant Country'.[250] Indeed, his fear is that the 'awful reality is that we probably have been influential', for example, in the case of China.[251] In other words, by its choices, Australia has the ability to influence the behaviour of the other players and hence the dynamics of the game.

Which view is right? Certainly, ascribing to Australian policymakers no ability to influence international trade policy seems too pessimistic given such past successes as the establishment of the Cairns Group. Still, the discussion in previous chapters suggests that at the current conjuncture, the global — and regional — momentum behind the PTA bandwagon is strong enough that the ability of any single medium-sized

economy to halt it must be questionable. Under such circumstances, an 'insurance policy' motive for PTAs to minimise the risks of exclusion (and maximise any available benefits) may be the most prudent policy response and is probably the strongest argument for pursuing a trade policy involving PTAs. Moreover, to the extent that slow progress at the multilateral level is due in part to the way in which international trade policy is currently vulnerable to domestic political pressures, agreements like AUSFTA also provide additional insurance against future political incursions into trade relations with a key partner.

Learning from AUSFTA

Still, even if the case for signing up to PTAs is granted, that leaves plenty of room for disagreement over the detail of actual agreements. The experience with AUSFTA highlights some of the problems and difficulties involved. For example, the treatment of agriculture, with one sensitive sector (sugar) excluded altogether — and with time-restricted liberalisation in other sectors such as beef and dairy — quite rightly drew a lot of criticism and seemed to give the lie to the argument that PTAs could succeed in areas where the multilateral system had failed. It also highlighted a standard feature of bilateral negotiations; the potential for an imbalance in power to influence the outcome.[252] Supporters of the agreement would claim that this is too pessimistic a read, pointing out that two-thirds of US agricultural tariffs were to be eliminated immediately after AUSFTA went into effect. But earlier modelling had suggested that the potential big gains for Australia were in the sugar (excluded) and dairy (restricted) sectors.[253]

More generally, the debate over AUSFTA also highlighted several of the difficulties involved in assessing PTAs discussed in Chapter 3. For example, we noted that while the standard way to assess the implications of a proposed PTA — to decide whether it leads to net trade creation and an improvement in economic welfare — is to use economic modelling, the results tend to be far from conclusive. In the case of AUSFTA, the government commissioned modelling by the Centre for International Economics (CIE).[254] The CIE estimated that the agreement would produce both trade creation and trade diversion, with the former outweighing the latter.[255] In terms of national welfare, the CIE results found that, in volume terms, the net impact of trade creation and trade diversion would be modestly negative for Australian national income, but that this projected loss would be more than offset by a positive price effect due to forecast changes in Australia's terms of trade. When other effects from the agreement were included, such as changes in technical efficiency and capital accumulation, the CIE estimates suggested that the 'most probable' effect of AUSFTA was a modest net gain in overall welfare, boosting Australia's net national income by an annual A$359 million, while sensitivity analysis indicated a 95 % probability that the annual gain to income would lie within a range of A$322 million and A$408 million.[256] However, in an illustration of the way in which modelling results are sensitive to the assumptions made by the modellers, an alternative assessment produced for a Senate Select Committee on the agreement put the projected annual welfare gain at a meagre A$53 million.[257] This discrepancy in results should not imply that these sorts of modelling exercises are not worthwhile — they perform a useful and important function by helping frame some of the key issues and providing a framework for arguing over potential costs and benefits — but it does emphasise their limitations in generating a definitive number.

Again, we noted in Chapter 3 that rules of origin (ROOs) can be a particularly problematic feature of PTAs. AUSFTA incorporates detailed requirements for the manufacturing sector, with particularly heavy restrictions relating to textiles. The CIE assessment, for example, noted that the vast majority of Australian textile and clothing exports would not be eligible for preferential access under AUSFTA given these rules.[258] Australia's Productivity Commission[259] has constructed an index that estimates the relative restrictiveness of ROOs for various PTAs. It finds that the ROOs that will apply in AUSFTA will be of medium to high restrictiveness and will be more restrictive than those applying in pre-existing Australian agreements.[260] One reason that the Dee analysis gave lower estimates of welfare gains than the CIE report, for example, was that Dee reduced the overall effects of merchandise

trade liberalisation (by one-third) to take into account general compliance costs associated with ROOs.[261] Outside of the textiles and auto sectors, however, the low prevailing level of MFN tariffs suggests that the adverse implications of ROOs for AUSFTA — in the sense of gumming up trade — should be fairly limited, since the gap between MFN and preferential access rates is small.

Assessing the implications of AUSFTA also involved moving beyond trade to look at other provisions of the agreement. As we noted back in Chapter 1, one feature of the new terms of trade is the expansion of trading relationships into new areas and this has been a feature of the 'third wave' PTAs discussed in Chapter 3. One of the theoretical advantages of these new age PTAs is that they broaden the negotiations beyond trade in goods and services, and so allow for 'deeper' economic integration. This in turn raises the possibility of dynamic benefits that potentially could turn out to be much bigger than the one-off static gains generated by cutting trade barriers. AUSFTA contains provisions on labour and the environment, and covers areas such as investment regulation, competition policy, intellectual property rights and government procurement. Again however, it is difficult to gauge the net impact of all of these provisions. AUSFTA may well bring significant gains in terms of reduced frictions in doing business, but these are hard to quantify in advance.[262]

For example, some of the surveys discussed in Chapter 3 suggested that PTAs could have an important impact in generating new investment. For AUSFTA the CIE estimated that gains from a reduction in investor uncertainty due to changes in the Foreign Investment Review Board (FIRB) screening process could lead to a fall in Australia's equity risk premium that would in turn have a significant positive effect on investment and output, generating a large share of the total welfare gain expected from the agreement. In contrast, the Senate assessment argued that the changes to the FIRB process would have only minor implications for transactions costs and no impact on the risk premium at all.[263]

A further complication is that in some of these 'non-traditional' areas, such as the patents and copyrights that comprise intellectual property (IP) rights protection, the win–win (positive sum) logic of international trade does not necessarily apply.[264] There is no guarantee, for example, that the application of US standards of IP rights will be welfare-enhancing for the Australian economy. Ultimately, the assignment of IP protection is about how long the recipient of that protection should benefit from monopoly profits, so the increase in copyright protection under AUSFTA may well involve a straightforward redistribution away from the Australian consumer in return for few — if any — improved incentives for the creation of new intellectual property.

Yet another complexity in the assessment process is that PTAs are intended to be ongoing agreements, in that they can deliver additional gains even after the agreement has been signed. In the case of AUSFTA, for example, although the original agreement failed to include a deal on the temporary movement of business people, in April 2005 the government did succeed in winning new legislation from the US giving Australia a new visa category for business professionals, with a quota of 10,500, a win that was attributed to the positive effects of the agreement.

AUSFTA is also an example of two other trends discussed earlier: the penetration of trade policy into areas of national economies that were once thought to be the preserve of domestic policy, and the use of PTAs as a tool to secure strategic interests. In the case of the first of these, some of the strongest debate over AUSFTA related to its possible implications for the Pharmaceutical Benefits Scheme, with questions over whether discussion of such policy should even be part of trade negotiations. In the case of the second, the government made it clear that one of the aims of AUSFTA was to move the economic relationship with the United States on to a similar footing to the security relationship.[265]

Not surprisingly, these various arguments left the general public divided on what the agreement would bring to Australia. According to a poll commissioned by the Lowy Institute, for example, 34 % of respondents thought that AUSFTA would be good for Australia, 32 % thought it would be bad, and 34 % thought it would make no difference.[266]

A new era for trade policy

In the event, AUSFTA was approved by parliament and went into effect from the start of January 2005. Its entry into force effectively marked a new era for trade policy, confirming as it did that Canberra was now firmly embarked on the preferential trade route. As one of the most prominent critics of that policy shift conceded: ‘For now, the Australian policy debate about whether Australia should enter new preferential trading arrangements has been concluded decisively. For the time being, there is an irresistible momentum towards the proliferation of preferential arrangements involving all substantial economies in the Asian Pacific region.’ [267]

Chapter 7

Conclusion:

managing the new terms of trade

The new terms of trade

This Paper has outlined some of the significant changes in both the global and regional context — the 'new terms of trade' — within which Australian trade policy operates. At the global level the rise of vertical specialisation, the increasing 'tradeability' of services and the associated rise of offshore outsourcing, and the emergence of new trading powers like China and India have all contributed to a rise in the importance of trade to national economies. At the same time, the international policy environment has also changed, with the multilateral system under strain, and with the rapid proliferation of PTAs. Many of these global trends are particularly evident in East Asia, where the rising economic integration apparent in increasing intra-regional trade is being accompanied by moves towards regional policy initiatives and a swiftly expanding web of PTAs, with China playing a key role in both developments.

These international trends have their counterparts at the Australian level, both in the form of the changing structure of Australian trade flows and in terms of a strategic shift in Canberra's trade policy. The decision to combine Australia's traditional reliance on multilateralism with a turn to preferential trade has been controversial.[268] But as the previous chapter noted, with three new PTAs on the books already, and with likely deals with China, Malaysia, the UAE and ASEAN in the future, there can be little doubt that there has been a fundamental restructuring of the policy framework.

While the environment for trade policy has never been stagnant, the sum of these changes does add up to a new context for Australian trade policy. Given these new terms of trade, what should be the future priorities and objectives for trade policy? In the remainder of this chapter we sketch possible answers to this question, although the degree of influence that Australia can exercise in each case varies. To parallel the rest of the Paper, we focus on policy challenges at the global, regional and national level.

Safeguarding the international trading system

The most important objective for trade policymakers everywhere, not just in Canberra, continues to be supporting and safeguarding the multilateral system. This requirement needs to remain at the heart of trade policy, since the multilateral system will remain indispensable for the health of the world economy. One big lesson of the 1930s, when the international economy splintered into closed and competing trade blocs, is the need for a system of international rules and cooperation that can maintain the free flow of trade. It is possible that bilateral and regional agreements can complement such a framework, but it is extremely unlikely that they could ever hope to replace it.[269]

Sometimes the case is advanced that in today's new global economy the need for the WTO is much reduced. Formal, 'at the border' trade barriers in many of the world's economies are now relatively low, and this fact together with improvements in communications technology and lower barriers to capital movements, has arguably made traditional trade barriers less of a concern to businesses. There is some truth in this. But crucially, in many ways the need for a functioning multilateral system is now more pressing than ever: the tensions between Beijing

and Washington over Sino–US bilateral trade imbalances and the protectionist responses by both Brussels and Washington to increased imports of Chinese textiles following the end of global quotas in early 2005 are both telling symptoms of some of the strains in the developed world generated by China's emergence as a new trading power. Assuming the pace of Chinese economic expansion continues to be close to its potential, such strains are set to continue, and quite possibly intensify. Of course, in one sense we have been here before: current tensions look a bit like a replay of US–Japanese trade spats in the 1970s and 1980s. But Japan was a US Cold War ally, while China is perceived by many in Washington as a long-term strategic competitor, which, all else being equal, decreases the chances of successfully defusing trade disputes in the absence of some form of impartial broker.[270]

To this combustible mix add the combination of India's services-based model and the ever deeper penetration of trade (most recently as a product of offshore outsourcing) into national economies, and this suggests that further challenges to the rich countries' commitment to an open and liberal trading regime lie in store.

In order to manage these and other difficulties, a rules-based trading system is essential. The good news is that, to date, the multilateral system has acted as a successful check on protectionist pressures, not least through the workings of the dispute settlement process. So even though the momentum for further trade liberalisation has slowed, the system has still delivered in terms of protecting the existing level of free trade. However, there is a risk that it might not continue to do so if the liberalisation process ground to a complete halt, since this would be likely to inflict severe collateral damage on other parts of the system.

True, in Australia the rise of the new trading powers tends (rightly) to be viewed with much less alarm than in many other developed economies. China's resurgence for example is seen as more of an economic opportunity overall than as an economic threat, a judgment currently being borne out by the respective trends in Australian export and import prices. India's services-based model may ultimately involve more adjustment strains, but here too the correct judgment is that Australia has far more to gain than to fear. Even so, the importance of the WTO as an arbiter for future trade disputes is particularly relevant for economies like Australia. While trading superpowers like the United States or the EU may be able to operate effectively in an international economy lacking a strong rules-based framework, such an environment would be a far less comfortable place for a medium-sized player like Australia. This would particularly be the case if the world moved towards a system of competing trade blocs, which, for example, could pose uncomfortable policy choices in the event of trade tensions between an East Asian and an American grouping.

Moreover, the multilateral system, for all its current problems, still remains the best hope for achieving any serious, significant progress on agricultural liberalisation. As is evident from the composition of our exports (Chapter 6, Figure 6.3), freer international trade in agriculture continues to be a major trade policy objective for Australia.

Finally, it should be remembered that the original GATT was founded in part as an initiative to improve global security. In today's uncertain times, the security dividend from a well-functioning international trading system should not be underestimated.

Reinvigorating the multilateral process

While securing the good health of the multilateral system is an important general policy objective, it is clear that one feature of the new terms of trade is the significant strain that the system is now under (see Chapter 2). Perhaps the most pressing challenge facing trade policy therefore is the need to reinvigorate a faltering multilateral process. In the short term that means working to ensure that the current Doha Round does not end in ignominious failure; a complete collapse would risk fatal consequences for the multilateral system as a whole. Even if the system survived, it would be in such bad shape that the task of rejuvenating it would become that much harder. Granted, there is the possibility that a major crisis could at least concentrate policymakers' minds. But the risks involved would be substantial. Instead, and far from ideal, even a lowest-common-denominator compromise agreement would at least keep the multilateral process moving forward. Unfortunately, at

the time of writing even that lowly prospect appears to be in jeopardy. A second short-term challenge is ensuring that the WTO — which currently has an extremely modest annual budget compared to other international financial organisations such as the IMF and World Bank — has sufficient resources to fulfil its mandate.[271] In the long term, however, policymakers need to think harder about ways to improve the effectiveness of the multilateral system itself, something that will (almost certainly) require institutional reform.

Specifically, the system needs to be able to deliver real progress on trade liberalisation within an acceptable period of time. In order to do this, the current negotiating process needs to be streamlined. Some observers have suggested that a relatively minimalist approach might suffice: overhauling processes and procedures while avoiding major institutional change.[272] However, while efforts to improve negotiating procedures would certainly be worthwhile, any long-term solution is likely to involve more far-reaching changes, including a clear-eyed review of the practices of requiring consensus for all WTO decisions and of involving all members in WTO outcomes.

The need to at least think about changing the consensus requirement was canvassed in a recent report by a consultative board to the WTO director-general on the future of the WTO. However, the consultative board also pointed out that consensus has some valuable attributes: in particular, by protecting weaker members it gives the system an important element of legitimacy and acts as a sort of procedural equivalent to the core MFN principle. As an alternative, the board suggested that the WTO could consider an approach whereby any member considering blocking a measure which otherwise would have very strong support should do so only if it first declared in writing, with reasons included, that the matter was one of vital national interest.[273] This would seem to be a reasonable first step, but its impact would need to be reviewed to see whether further, more dramatic changes were warranted.

Watering down the requirement for consensus could be usefully supplemented by a retreat from the 'single undertaking' approach implemented after the Uruguay Round. One approach to this would be the idea of 'variable geometry' in WTO commitments; the idea that members could take on more or fewer obligations as they chose. Such a plurilateral approach would allow those WTO members who wanted to pursue more ambitious commitments to do so, albeit at the cost of creating a multi-class membership structure.[274] Still, if the alternative to a tiered membership structure is to see the major players effectively opt out of the organisation all together, such a cost may well be worth paying. Moreover, from a practical perspective, if future negotiations focused on a smaller number of the more significant traders — which would have to include the major developing as well as developed countries — this would still account for (by far) the bulk of world trade.[275]

Convincing the sceptics

One complication here is that any changes in the institution do not only have to secure the buy-in of the economies that constitute the WTO's membership. While member governments have the final say, the growing role of civil society means that members — at least in the developed world — now have to keep at least half an eye on these other constituents. An increasingly prominent role for NGOs is another feature of the new terms of trade and one that involves more work from government in terms of managing another vocal constituency for trade policy. Many NGOs already feel that the WTO is not sufficiently 'democratic' and any moves that are seen as somehow reducing the legitimacy of the WTO (diluting consensus, a greater voice for the major players) would run the risk of further tarnishing the reputation of the organisation in the eyes of an important section of civil society.[276] The WTO is making efforts to reconcile its critics. For example, at the time of writing there was the suggestion that the dispute panel might open (some of) its hearings to the public. This would go some way to addressing concerns about lack of transparency and accountability, although it would rely on the parties involved waiving their rights to secrecy. Again, the director-general and staff of the WTO secretariat now meet regularly with NGO representatives, and briefings are provided to civil society groups on the work of the organisation's councils and committees. The WTO's Appellate Body (a standing body

that hears appeals relating to rulings under the disputes settlement process) has allowed NGOs to file so-called *amicus curiae* (friend of the court) briefs.[277] However, given that at least some of the objections to the WTO are basically objections to international economic integration itself, ultimately it may be impossible to deliver an institution that can both act as a successful manager of globalisation and keep all of the NGO community on side. The WTO will have to continue to live with at least some disgruntled NGOs.

A related (but more fundamental) challenge is the need to sell more effectively the benefits of the multilateral system to a sceptical public. As discussed in Chapter 2, there is a good case to be made that the current rules-based system has been one of the most successful economic policy making exercises in history. It has certainly presided over a period of strong trade growth and rapid international integration. Yet the current trading regime has a poor public image. A big part of the problem is that a large section of public opinion is not just sceptical about the system itself, but about the free and open trade that it was created to encourage. Indeed, as noted earlier, it is even possible that the very nature of the existing system, with its focus on reciprocity in trade negotiations, has contributed to the still pervasive view that exports are good and imports bad. That mercantilist calculus needs to be challenged and changed if the benefits of an open trading system are to be truly valued by the average voter.[278] To this end, politicians and economists need to find new and more persuasive ways of making the case for a free and open trading regime.

At the same time, under the new terms of trade a greater share of national economies and voters are feeling potentially exposed to international competition, particularly in the service sector that covers most employment in developed economies. Even if voters can be convinced that reinvigorating the multilateral system is vital for the long-term health of their own and the international economy, they will also need to be reassured that the safety nets are in place to protect those who lose out in the subsequent adjustment process, and that the appropriate mechanisms (in terms of education and training) are being provided to allow their effective participation in the new global economy. This will particularly be the case if it turns out that one implication of the new terms of trade is a significant shift in income distribution. For example, one consequence of the effective addition of China and India to the international economy could be a relative shift in the balance of economic power away from labour and toward capital, a development likely to inject yet more sensitivity into the trade policy debate (see Chapter 1).

Making a global pitch

These twin objectives — the near-term one of concluding the Doha Round and the longer term one of reinvigorating the WTO — require the cooperation of the world's major trading powers. This means that Canberra's ability to directly influence the outcome is limited, but still far from insignificant. At the time of writing Australia was playing an important part in keeping the Doha Round alive, for example, through its role as a member of the Five Interested Parties (FIPs), a sign that Canberra continues to have an influential voice at Geneva. By promoting institutional reform, and perhaps by encouraging fellow members of the Cairns Group to consider the same, Australia could play an important role in rejuvenating the WTO.

Australia could also work at making the case for reinforcing the multilateral system through other key international organisations in which it has a prominent voice. In particular, Australia's upcoming position as the host of first the G20 (in 2006) and then APEC (in 2007) provides it with a useful opportunity to advance the cause of WTO reform at an appropriately high level. What better economic theme for these two major meetings to focus on than reinvigorating the global trading system?

Rewriting the rules on PTAs?

In the context of a world economy marked by rapidly proliferating PTAs, another element of WTO reform that is sometimes raised is an initiative to rewrite the rules governing preferential trade. As discussed

in Box 7, the current multilateral framework for PTAs is effectively non-operational, and so there is at least a case for providing a better set of regulations.[279] In fact, the WTO has already made efforts to tighten up its regulation of PTAs: following the Uruguay Round the General Council established the Committee on Regional Trade Agreements with the dual mandate of examining individual agreements and considering their systemic implications for the multilateral system. The Doha Round also includes negotiations aimed at 'clarifying and improving' the existing WTO mechanisms. Indeed, Australia has historically played a significant role in multilateral discussions on regulating PTAs.

Unfortunately, however, in the words of the consultative board there are 'now just too many WTO members with interests in their own regional or bilateral arrangements for a critical review of PTA terms to take place and for consensus on their conformity to be found.'[280] Years 'of discussion in the GATT/WTO … have had no impact on the spread or content of [PTAs]. Improving the enforcement of Article XXIV or strengthening/changing WTO disciplines on regionalism is unlikely to fare any better.'[281]

An alternative approach might be to focus on one particularly problematic aspect of PTA proliferation — the effect of multiplying and incompatible rules of origin (ROOs) — and one moreover which runs counter to a key trend in international trade flows, the rise of international production chains. Several observers have proposed that the WTO should encourage a global standard for ROOs in order to limit distortions and increase the ease with which existing agreements could be stitched together into wider trade blocs. Once again the record offers little hope: multilateral talks aimed at harmonising *non*-preferential ROOs have been under way for roughly a decade now, without yet reaching a conclusion. Still, there may be a case for pushing this type of initiative at a regional level (see below).

Another possibility would be for the WTO to focus on its role of increasing transparency and to devote more time and resources to conducting its own reviews of existing PTAs, which could at least provide an outside assessment of how PTAs were working in practice.[282]

Overall, however, the best hope for reducing the attraction of bilateral or regional agreements, and hence lowering the risk that PTAs turn out to be stumbling blocks rather than building blocks for global free trade, is to restore the attractiveness of the multilateral system.

Influencing the regional trade agenda

While the global policy framework is of critical importance to Australia, the geographic composition of Australia's trade profile means that developments in East Asia are also crucial. Here the new terms of trade confronting Canberra are dominated by the shift to greater regional trade integration, driven both by market forces and by policy, with the rising influence exerted by China on both of these trends a key element.

Looking ahead, there are several possible scenarios for regional trading arrangements. Perhaps the downside scenario most often canvassed in the past has been the prospect of a region-wide arrangement that left Australia on the outside. It is clear that this would be a perilous place to be, given the importance of regional markets; an intuition confirmed by the economic modelling reviewed in Chapter 4, which finds significant welfare losses for those regional countries excluded from any significant East Asian trade bloc.[283] Australia's participation in a series of bilateral agreements, including the existing deals with Singapore and Thailand, and the prospective ones with China, Malaysia, and AFTA/ASEAN have mitigated some of the risks associated with this type of scenario.

An alternative scenario would be the emergence of a regional trading bloc that *included* Australia. While the welfare benefits from membership could well be significant, and membership viewed as something of a policy prize, this scenario would not necessarily be without its own complications. In particular, much would depend on the degree to which the bloc was open to the rest of the world, on the implications of a potential three-bloc world for global trading frictions, and on the warmth of relations between an East Asian bloc and the United States. To take just one example, a Beijing-led trade arrangement that was seen primarily as a vehicle for extending Chinese (and limiting extra-

regional) influence would presumably be viewed with some disquiet in Washington and as such could test Australian bilateral relations on several fronts.[284] A regional trading bloc *could* be an important building bloc towards global free trade, but the spirit and the architecture of the agreement would be important determinants of such an outcome.

A third possibility is that the current and historical tensions between the major trading powers of Northeast Asia will preclude any serious move to a coherent region-wide trade bloc. Instead, a system of hub-and-spoke arrangements based around Beijing and Tokyo could emerge. At best, this would leave the region with a mess of overlapping agreements: at worst, it could see trade policy subsumed into a wider competition for strategic leadership in the region, again with uncomfortable consequences for economies like Australia, which would be at risk of being squeezed in the middle.

A final scenario is that the current regional turn to PTAs runs out of steam, with agreements turning out to have more symbolic than practical importance. This could happen because many of the agreements negotiated turn out to have little practical substance, or because the costs and barriers associated with ROOs prove to be incompatible with the current pattern of regional trade with its emphasis on vertical specialisation, or because a successful reinvigoration of the multilateral system reduces the relevance and attractiveness of preferential trade.

Several of these scenarios could be quite problematic from an Australian policy perspective, so the continued evolution of the various regional trade policy initiatives warrants continued and careful monitoring by Canberra in order to see which, if any, of these possible outcomes looks likely. The more challenging aspect for policy is what can then be done to influence the evolving regional trade structure in a way best designed to meet Australia's interests.

Joining the EAS and resurrecting APEC?

Aside from continuing the current policy of negotiating PTAs with key regional trading partners, which may help minimise the danger of being frozen out of any future initiatives and which can offset the distorting effects of preferences that have already been granted, is there anything else that can be done to try and shape the regional environment?

To try and influence the regional environment means being part of the processes and the organisations that will manage that process. In the future, that role could be fulfilled by the East Asian Summit (EAS), so trade policy provides at least one important reason for Canberra's participation.

Another option that is well worth considering is for Australia to work with other member economies to resurrect the trade policy component of APEC.[285] There is at least some economic logic here: most modelling shows that an APEC-wide agreement would lead to welfare effects for members superior to an agreement restricted to East Asia, hardly surprising given the region's strong trade ties with the United States. Moreover, the agreement would return to the original idea of avoiding 'drawing a line down the Pacific', and by binding together two of the three major global trading areas, it would increase the probability of trading blocs becoming building blocks towards global free trade (as arguably APEC did in the mid-1990s when it contributed to the successful conclusion of the Uruguay Round).

In fact, there have already been some efforts to move in this direction. At the November 2004 APEC Leaders Meeting, the APEC Business Advisory Council (ABAC) presented a plan for a 'Free Trade Area of the Asia–Pacific (FTAAP)'.[286] Supporters of the proposal argued that a FTAAP would counter a 'very real risk of disintegration of the Asia–Pacific region that is evident in the progress of Asian-only cooperation on one side of the ocean and a Free Trade Area of the Americas on the other side' as well as helping APEC meet its own (Bogor) goals of regional free trade.[287] However, APEC ministers responded coolly to the FTAAP idea, suggesting that for now at least the appetite for pushing the organisation in this direction is limited. Moreover, APEC as it currently stands lacks the institutional architecture to carry out such a project. Previous efforts to push trade liberalisation through the organisation (IAPs and EVSL) have been disappointing, so history is not encouraging (see Chapter 5). Finally, the idea that APEC can serve as an effective force may simply be past its sell-by date.[288]

Despite these difficulties, however, the idea of returning to APEC to help mould regional trade structures is one that is worth pursuing.[289] In the near term, current political realities may rule out this taking the form of an FTAAP (although if the Doha Round did collapse, such an initiative could return to the agenda). One alternative would be to promote APEC as a forum for discussing how to harmonise existing PTAs (based as they are on different ROOs and other arrangements), for how to make current agreements open to a wider membership and even for work on creating a standard regional template for future agreements, which would improve the possibilities for bolting together existing arrangements to create something more coherent in the future. Such an initiative could be seen as a complement to existing proposals on trade facilitation that are aimed at increasing regional integration. There have been some early efforts in this direction. Thus at the November 2004 Leaders Meeting, the final declaration commended to policymakers the APEC statement on best practice in PTAs, which includes calls for standardisation of ROOs and an openness to third party accession, along with a commitment to transparency, comprehensiveness and consistency with WTO guidelines.[290] Australia has played a part in these discussions, but in terms of achieving more concrete progress on effectively regulating and harmonising such agreements, there remains a long way to go.

The APEC option is also one that Canberra could usefully raise with Washington. With the emergence of the East Asian Summit, the United States risks being left out of the game in terms of the developing regional architecture. Reinvigorating APEC would provide an important way for Washington to re-engage with the region, and trade policy would be a good and useful place to start.

In the meantime, perhaps the best policy option open to Australia at the regional level is to try to ensure that the various regional PTAs it participates in are as consistent in content and design as possible, and if possible are amenable to expansion to other countries.[291]

Exercising the PTA option: maximising benefits, minimising risks

With Canberra's trade policy now committed at least in the near term to using PTAs in tandem with the multilateral route, an important objective for policy at the level of the individual agreements themselves should be to maximise the benefits associated with PTA membership while minimising the risks associated with the potentially adverse consequences of preferential trade. There are two potential areas for policy action here:

- one relating to the choice of PTA partners; and
- the other relating to the design of future PTAs.

Choosing partners

One place to start would be to establish a set of guidelines that inform the decision over where and when to pursue negotiations. In fairness, the current approach to picking partners has been framed around some broad principles: the government says that it is 'willing to consider free trade agreements with significant individual economies or regional groupings, where they would deliver faster and deeper liberalisation than the multilateral process' and which 'are comprehensive in scope and coverage [and] can complement and provide momentum to … wider multilateral trade objectives'.[292] But otherwise concrete details are lacking: in the words of one observer, current policy appears to be ad hoc in nature: 'we are doing little more than picking cherries as the opportunities arise. Although we're in the middle of a major change in the way we manage trade relations, the government has almost been at pains to avoid articulating a change in policy.'[293]

There is therefore a strong case for presenting a formal policy framework that sets out clearly the criteria by which partners will be chosen. This would add transparency and consistency to the process.

An obvious starting-point is the recognition that negotiating resources are limited: a resource constraint exists that effectively limits new

agreements to what is feasible after taking into account WTO-related obligations. It therefore makes sense to restrict PTA negotiations to major trade and investment partners (such as the United States and China) and key regional counterparts.[294] These guidelines could also link into the design principles of future PTAs. Clearly, there is a trade-off between retaining the flexibility to negotiate and providing a formal framework, but at present the trade-off is arguably paying too little attention to the benefits of the latter.

This leads to another important aspect of partner choice: should the desirability of a prospective PTA be assessed purely on economic grounds, or (as suggested in the government's White Paper) should other foreign policy factors play a role? The economic purist's response is straightforward: trade policy choices should be made solely in terms of the economic benefit. This has several advantages, not least that it makes it easier to deliver clarity and consistency in policy choice and avoid capture by special interests. But in practice current policy clearly takes non-economic factors into account: for example, in a speech to an Australia–China FTA conference held in August 2004, the then Department of Foreign Affairs and Trade secretary, Dr Ashton Calvert, told the audience that issues worth considering 'naturally include commercial and economic considerations and matters of international and domestic trade policy. But they also rightly include broader strategic considerations, and the strengths and qualities of the Australia–China bilateral relationship.' He went on to argue that an 'FTA with a major regional trading partner and an emerging global power like China is as much about strategically positioning our relationship for the long term as it is about the benefits for greater trade and investment flows that would come from removing barriers in each country.'[295]

Some commentators have been highly critical of what they see as a *new* entangling of trade and security policy in the current policy stance.[296] In an ideal world, it *would* be better to keep trade and strategic/foreign policy interests separate. But the assumption that trade and (geo-)politics have been separate in the past seems questionable: we described in Chapter 2 how the current multilateral system itself has some strong security origins, and foreign policy has clearly played a role in past Australian trade policy decisions (for example the formation of the CER, participation in economic and trade sanctions, and APEC itself). And it is certainly the case that at an international level trade and politics are intermingled: the EU has long used trade policy as a major instrument of foreign policy and Washington appears to be treading a similar path.[297] However, it is also clear that at both the international and national levels the relative emphasis on foreign policy as opposed to economic objectives is something that changes over time. Currently we seem to be in a period where government places relatively more weight on foreign policy.

This shift increases the complexity of the policy decision and boosts the case for developing a clearer statement about the mechanics of choosing PTA partners, including more discussion on the relative weights that are given to economic and non-economic objectives. This is important because selling a particular PTA on the grounds of general strategic benefits is not convincing: the case needs to be made as to precisely what those benefits will be, and why it requires a PTA to deliver them. This is particularly important to ensure that if compromises are made in terms of the economic content of the agreement, they are not made for some ill-defined (and ultimately non-existent) foreign policy payoff. One implication is that it would be better for separate cases to be advanced for the trade and foreign policy motivations for a given agreement.

Finally, while the mingling of trade and foreign policy may have become an unavoidable feature of the PTA process in particular, and of trade policy in general, and while in some cases it *may* have benefits, it should be recognised that there are also risks involved. At the time of writing, for example, there was a growing debate about Australia's position in the event of deteriorating relations between China and the United States. There was also discussion of the tensions between China and Japan. It would clearly not be in Australia's interests for trade relations with the country's three most important trading partners to be used as bargaining counters in the event of bilateral disputes between any two of them.[298] Making trade relationships part of the broader political and strategic relationship can cut both ways.

Designing 'better' PTAs

A second way of maximising the benefits and minimising the risks associated with individual PTAs is to focus on designing 'good' agreements. This is particularly the case if the policy endgame will involve participation in a whole series of PTAs. In theory at least, 'combining a number of [PTAs] could effectively substitute for free trade'. But in practice, this would mean overcoming the problems created by different ROOs and other administrative requirements, and would also require that the costs of trade diversion incurred en route were not too high.[299]

The most straightforward way to minimise the adverse consequences of PTAs is to push ahead with continued trade liberalisation on a broad front, including unilaterally. As noted earlier, Australia is in fact already a very open economy by international standards, with low tariff barriers and relatively few tariff peaks. Perhaps more relevant in the Australian case, therefore, is that to the extent that the granting of preferences goes beyond merchandise trade to cover areas like investment, then a process of parallel, broader liberalisation should be pursued here too: there seems to be no clear reason why (say) Chinese investors after a successful Australia–China FTA should have privileged access to purchase Australian assets ahead of other interested parties. Indeed, if this were to be one outcome of an Australia–China agreement, there would possibly be considerable disquiet among other key regional trading partners worried about their own access to resources. As recognised above, the policy implication that follows — unilateral liberalisation — is often a hard sell, although it is worth remembering that in the relatively recent past Australia has demonstrated that governments can deliver successfully in this area.

In terms of designing PTAs themselves, the standard prescription is to aim for 'best practice' agreements. In fact, Canberra already says that its PTAs should be consistent with the requirements laid out by the WTO. This is a helpful start, but as we have seen, the requirements laid down by Article XXIV of GATT (and its GATS counterpart) are only an imperfect first step towards regulating PTAs, a necessary but not sufficient condition.

So what *should* 'best practice' mean? One useful requirement is that PTAs should aim to deliver the widest possible coverage and to refrain from leaving key sectors in the 'too hard' basket. One of the most powerful criticisms of AUSFTA, for example, was its failure to deliver a fully comprehensive deal on agriculture, given the exclusion of sugar.

A second requirement is that the ROOs used in PTAs should be such as to maximise trade creation by minimising administrative and compliance costs. Ideally, there should also be consistency across future agreements, and the least restrictive ROOs possible should be utilised. The Productivity Commission, for example, has set out some design principles for ROOs that would help maximise the benefits of bilateral liberalisation under a PTA, including the avoidance of product-specific requirements.[300]

A third is that PTAs should seek to deliver on their promise of 'deep integration' by seeking to reduce costs and barriers to trade and investment above and beyond those associated with traditional trade policy, such as customs procedures and other issues that typically fall under the heading of trade facilitation. There are also potentially large benefits associated with reaching agreements on codes, standards and mutual recognition. However, there is a strong case to be made here for ensuring that convergence is towards internationally accepted standards, which will not necessarily always be the same as those pushed by bilateral negotiating partners with a specific agenda in mind.[301]

More generally, future PTAs should ideally conform as closely as possible to a standard template, in order to make it easier to bolt together such agreements in the future. This leads in turn to another theoretically attractive requirement: that PTA membership should be open to other partners who are prepared to meet the terms of the existing agreement. In practice, however, most PTAs involve membership restrictions, so such a requirement could prove tough to deliver unless it was part of larger process (for example, under the auspices of APEC as discussed above).

Finally, as suggested during the discussion on partner choice, it would be helpful to produce a policy framework codifying at least some of these objectives and requirements for PTA policy. Thus along with decision

criteria for appropriate partners, this could set out the minimum level of content (for example on agriculture and other key sectors) that would be acceptable in future PTAs, and aims and objectives in terms of preferred standards and codes. Such a framework would be a form of 'position statement' going into future PTA negotiations, and as such could also indicate for example which areas of domestic policy would and would not be up for grabs. Producing an overall framework like this would improve transparency in the decision-making process, by providing clarity in the degree to which the government is prepared to trade off one objective (say, making sure that an agreement comprehensively covers agriculture) with another.

As noted earlier, there is clearly a trade-off to be managed here between providing enough guidance to be useful while still accepting the flexibility required by what is, after all, a negotiating process. But while too much clarity may not be welcomed by politicians and policymakers, by restricting negotiating room, there could be longer term payoffs in terms of greater public understanding and acceptance of future PTAs.

A framework could also have benefits in terms of the negotiating process. One problem facing governments is that once they have embarked on a high profile negotiation with a major trading partner (like China or the United States) it may be very difficult to walk away even from a poor agreement, since so much political capital has been invested in the negotiating process. The presence of a set of guidelines as to what constitutes an acceptable deal could provide a mechanism for giving the negotiators such an option.

Stress testing the PTA policy: the case for regular review

Lastly, one of the themes of this discussion has been that of the difficulties involved in assessing potential PTAs: the experience with AUSFTA, for example, showed that modelling results could deliver moderate welfare gains, negligible welfare gains, and even welfare losses depending on the assumptions made. As Andrew Stoler noted at the time, we still 'seem to be a long way from being able to conduct reliable overall assessments through consistently agreed means'.[302] This means that ultimately we may not be in a position to judge the overall impact of a given agreement until it has been in operation for several years.

There is therefore a strong case to be made for introducing a regular review process for existing PTAs. As suggested above, one option might be to press for a regular review by the WTO of all PTAs. But there is no need to wait for the WTO since from an Australian perspective many of the same functions could be fulfilled by a formal review by the Productivity Commission, say every three to five years, to assess the actual performance of agreements once they have been implemented, and judge what is working, and what is not. The combined findings of such reviews would then form an important stress test for the whole PTA project.

PTAs are intended to be living agreements that are open to adaptation and growth. So an external, objective review would be a valuable way of ensuring that such promises are delivered. It would also provide useful lessons for the structure and negotiation of future agreements. Finally, in an international economy where production can quickly choose to shift location, it is important to be sure that policy initiatives like PTAs are delivering in terms of improving the trading environment, rather than creating administrative or other burdens that actually hamper the process of international exchange.

Notes

1 This more general debate was the theme of a Lowy Institute conference. See in particular Allan Gygnell's introductory comments in William Tow, ed. *Changing utterly? Australia's international policy in an uncertain age.* Sydney, Lowy Institute for International Policy, 2004.

2 This Paper draws on two earlier pieces: Mark P Thirlwell, *Is the international trading system fragmenting? Challenges for Australian trade policy.* Lowy Institute Working Paper in International Economics 1.03. Sydney, Lowy Institute for International Policy, 2003 and Mark P Thirlwell, *Are Australian policymakers operating in a new global economy?* Lowy Institute Working Paper in International Economics 2.03. Sydney, Lowy Institute for International Policy, 2003.

3 There are signs of 'new' terms of trade here too, in the sense that in 2005 Australia's terms of trade were at 30-year highs, following their largest cumulative increase since the early 1970s. While this was large by historical standards, it was not unprecedented: Australia's largest terms of trade shock came in the 1950s, when the Korean War produced a sharp rise in the price of wool. Reserve Bank of Australia, Commodity prices and the terms of trade. *Reserve Bank Bulletin (April)* 2005.

4 Daniel Yergin and Joseph Stanislaw, *The commanding heights: the battle for the world economy.* New York, Simon & Schuster, 2002. p 393.

5 Thomas L Friedman, *The Lexus and the olive tree.* London, HarperCollins, 1999. pp xiii–xiv.

6 The debate over whether we are living in a new global economy is discussed more generally in Thirlwell, *Are Australian policymakers operating in a new global economy?*

7 Michael Mussa, Factors driving global economic integration, in *Global economic integration: opportunities and challenges: a symposium sponsored by the Federal Reserve Bank of Kansas City.* Jackson Hole, Wyoming, 2000.

8 David Reynolds, *One world divisible: a global history since 1945*. The global century series. London, Penguin Books, 2001. p 1. Reynolds goes on to argue that recent decades have been marked by both greater integration *and* greater fragmentation.

9 Kevin H O'Rourke and Jeffrey G Williamson, *Globalization and history: the evolution of a nineteenth-century Atlantic economy.* Cambridge MA, MIT Press, 1999. p 6. One possible date for the birth of this first global economy is 1869, the year in which the Suez Canal and Union Pacific Railroad were completed, helping steamships and railroads create truly global markets for standardised commodities such as wheat and wool. Paul R Krugman, Growing world trade: causes and consequences. *Brookings Papers on Economic Activity* (1) 1995. p 330.

10 Richard E Baldwin and Philippe Martin, *Two waves of globalization: superficial similarities, fundamental differences*. NBER Working Paper No 6904. Cambridge MA, National Bureau of Economic Research, 1999. For example, Paul Masson concludes that modern international economic integration 'is in several respects less pronounced than the pre-World War I period'. Paul Masson, *Globalization: facts and figures*. IMF Policy Discussion Paper PDP/01/4. Washington DC, International Monetary Fund, 2001. Similarly Jeffrey Frankel judges that nineteenth century economic integration was 'at least as impressive as the current episode'. Jeffrey A Frankel, *Globalization of the economy*. NBER Working Paper No 7858. Cambridge MA, National Bureau of Economic Research, 2000.

11 Although this is not necessarily the case for individual economies.

12 A key factor was growth in intra-European trade, particularly intra-industry trade. This 'take-off' in European trade, particularly in the 1960s, was probably a consequence of both growing European integration and a reduction in the structural barriers to trade thrown up during the 1930s. See Chapter III in United Nations Conference on Trade and Development, *Trade and development report, 2003.* Geneva, United Nations, 2003. Especially pp 45–47.

13 Lawrence H Summers, Regionalism and the world trading system, in *Policy implications of trade and currency zones: a symposium sponsored by the Federal Reserve Bank of Kansas City.* Jackson Hole, Wyoming, 1991.

14 One explanation for this trend is different income elasticities of demand: as income rises a smaller share of expenditure tends to be devoted to food, implying that the share of food in world consumption (and hence trade) will tend to fall over time. Other explanations include differences in the speed of trade liberalisation between primary products and manufactures, and the emergence of international production chains. United Nations Conference on Trade and Development, *Trade and development report, 2002.* Geneva, United Nations, 2002.

15 World Trade Organization, *World trade 2004, prospects for 2005.* World Trade Organization 2005: http://www.wto.org/english/news_e/pres05_e/pr401_e.pdf [cited 30 August 2005].

16 A survey by UNCTAD looked at 225 products for the period 1980–98. While exports of some products grew twice as fast as world trade, others declined in absolute terms. Primary products showed some of the most sluggish (or even negative) growth rates over this period, while the fastest growing category of exports was electronic and electrical goods, which saw its share in world exports roughly triple. Chapter III in United Nations Conference on Trade and Development, *Trade and development report, 2002*.

17 Measured on a values basis. In volume terms the gains were even greater, since the price of office and telecommunication equipment fell during this period. World Trade Organization, *World trade report 2003.* Geneva, World Trade Organization, 2003.

18 More precisely, intra-industry trade is trade in products within the same standard industrial classifications.

19 Chapter VI in Organisation for Economic Co-operation and Development, *OECD economic outlook (71)*. Paris, Organisation for Economic Co-operation and Development, 2002. In contrast to the United States, Australia has 'low and stable' intra-industry trade, accounting for about 30 % of total manufactured trade. This is typical for economies where non-manufactures are at least 40 % of total exports (or about double the world average).

[20] See RC Feenstra, Integration of trade and disintegration of production in the global economy. *Journal of Economic Perspectives* 12 (4) 1998. Also David Hummels, Dana Rapoport and Kei-Mu Yi, Vertical specialization and the changing nature of world trade. *Economic Policy Review (Federal Reserve Bank of New York)* 4 (2) 1998.

[21] See Chapter III in United Nations Conference on Trade and Development, *Trade and development report, 2002*. pp 62–65.

[22] Michael D Bordo, Barry Eichengreen and Douglas A Irwin, *Is globalization today really different than globalization a hundred years ago?* (paper presented at the Brookings Trade Policy Forum on Governing in a global economy, Washington DC, 1999). The growth of trade in intermediate products implies that some of the measured growth in world trade represents 'double counting', in the sense that multiple cross-border transactions will be associated with the same final product.

[23] Chapter III in United Nations Conference on Trade and Development, *Trade and development report, 2002*. pp 62–65. Other networks involve groups of smaller companies linked through international subcontracting.

[24] Ashoka Mody, Is FDI integrating the world economy? *World Economy* 27 (8) 2004. p 1196. Of the US$1.4 trillion total in 2000, roughly US$1.1 trillion went to developed economies. Even so, inflows to developing economies still rose by more than 600% over this period.

[25] There was a modest increase in FDI inflows in 2004, but this still left the value of FDI at less than half the 2000 peak. World Trade Organization, *World trade 2004, prospects for 2005.*

[26] United Nations Conference on Trade and Development, *World investment report, 2004: The shift towards services.* New York and Geneva, United Nations, 2004. This international production is fairly concentrated: in 2002 the world's 100 largest transnational corporations (a mere 0.2% of the total number worldwide) accounted for 14% of world sales by all foreign affiliates, 12% of their assets and 13% of employment.

[27] United Nations Conference on Trade and Development, *World investment report 2004: The shift towards services*. pp 97–98.

[28] While important, this trend should not be overplayed. For example, US data for the period 1990 to 2003 shows that US exports and imports of private services have expanded only marginally faster than the output of US service industries (ex government), leaving the ratio of trade to output roughly unchanged at less than 5%. This stands in marked contrast to goods industries, where the trade ratio rose from less than 30% in 1990 to 50% in 2003. So in the case of the world's leading services exporter, the globalisation of services as measured by cross-border trade is still far less advanced than for manufacturing, mining or agriculture. World Trade Organization, *World trade report 2003*. p 3.

[29] See for example, Mary Amiti and Shang-Jin Wei, *Fear of outsourcing: is it justified?* IMF Working Paper WP/04/186. Washington DC, International Monetary Fund, 2004. Lael Brainard and Robert Litan, '*Offshoring*' *service jobs: bane or boon and what to do?* Policy Brief No 132. Washington DC, The Brookings Institute, 2004.

[30] See Stephen S Cohen and J Bradford DeLong, Shaken and stirred. *The Atlantic Monthly* 295 (1) 2005. Especially p 114.

[31] World Bank, *Global economic prospects 2005.* Washington DC, World Bank, 2004. pp 49–51. The focus here is on informal regional blocs — that is, those delineated by measured trade flows — rather than the formal trade blocs created by policy initiatives that are the subject of Chapter 3.

[32] Chapter II in United Nations Conference on Trade and Development, *Trade and development report, 2004.* p 43.

[33] For one take on some of the implications of China's economic re-emergence in the world economy, see Mark P Thirlwell, China and the international economy. *CEDA Growth 55: China in Australia's future* (May) 2005. Also Mark P Thirlwell, *Shaking the world? China and the world economy*. Lowy Institute Perspectives. Sydney, Lowy Institute for International Policy, 2005.

[34] World Trade Organization, *World trade 2004, prospects for 2005.*

[35] United Nations Conference on Trade and Development, *World investment report 2004: The shift towards services*.

[36] Stephen Roach, *Getting China right*. Morgan Stanley Special Economic Study, 2003.

[37] Thomas Rumbaugh and Nicolas Blancher, International trade and the challenges of WTO accession, in *China's growth and integration into the world economy. IMF Occasional Paper No 232*. ed. Eswar S Prasad. Washington DC, International Monetary Fund, 2004.

38 David Hale, China's growing appetites. *The National Interest* 76 (Summer) 2004.

39 See International Energy Agency, *World energy outlook 2004.* Paris, IEA, 2004. p 265.

40 BP, *Statistical review of world* energy 2004. BP 2004: http://www.bp.com/subsection.do?categoryId = 95&contentId = 2006480 [cited 27 September 2005].

41 International Monetary Fund, The global implications of the US fiscal deficit and of China's growth, in *World economic outlook, April 2004.* Washington DC, International Monetary Fund, 2004.

42 GDP per capita measured at purchasing power parity. Thirlwell, *Shaking the world? China and the world economy*. pp 10–12.

43 See Mark P Thirlwell, *India: the next economic giant*. Lowy Institute Paper 01. Sydney, Lowy Institute for International Policy, 2004.

44 Diana Farrell and Adil S Zainulbhai, A richer future for India. *The McKinsey Quarterly*, December 2004.

45 Stephen Roach, *Outsourcing, protectionism and the global labour arbitrage*. Morgan Stanley Special Economic Study, 2003. p 5. Stephen Roach, *What about us?* Global: Daily Economic Comment, Morgan Stanley, 2004. p 4.

46 Richard B Freeman, *Doubling the global work force: the challenge of integrating China, India and the Former Soviet Bloc into the world economy.* Institute for International Economics 2004: http://www.iie.com/publications/papers/freeman1104.pdf [cited 31 August 2005].

47 See for example AG Kenwood and AL Lougheed, *The growth of the international economy 1820–1990*, 3rd ed. London, Routledge, 1992. pp 64–66.

48 Krugman, Growing world trade: causes and consequences. International Monetary Fund, Annex: globalization in historical perspective, in *World economic outlook May 1997.* Washington DC, International Monetary Fund, 1997.

49 Maurice Schiff and L Alan Winters, *Regional integration and development.* Washington DC, World Bank, 2003. pp 261–266. pp 236–239. We return to the idea of domino regionalism in Chapter 3.

50 Nicholas Crafts, *Globalization and growth in the twentieth century*. IMF Working Paper WP/00/44. Washington DC, International Monetary Fund, March 2000.

51 Piers Brendon, *The dark valley: a panorama of the 1930s.* London, Pimlico, 2001.

52 Douglas A Irwin, *Free trade under fire.* Princeton, Princeton University Press, 2002. p 159.

53 Ibid. pp 159–160.

54 The following section draws on material from several WTO publications, including World Trade Organization, *Trading into the future.* Geneva, World Trade Organization, 1997. See also World Trade Organization, *Understanding the WTO.* Geneva, World Trade Organization, 2003.

55 Peter Sutherland, Jagdish Bhagwati, Kwesi Botchwey, Niall Fitzgerald, Koichi Hamada, John H Jackson, Celso Lafer and Thierry de Montbrial, *The future of the WTO: addressing institutional challenges in the new millennium. Report by the Consultative Board to the Director-General Supachai Panitchpakdi.* Geneva, World Trade Organization, 2005. pp 20–21. The actual benefits developing countries derive from the GSP and other such arrangements is a subject of controversy.

56 The Trade Policy Review Mechanism was established during the Uruguay Round at the December 1988 Ministerial Meeting.

57 Paul R Krugman, What should trade negotiators negotiate about? *Journal of Economic Literature* 35 (1) 1997. p 113.

58 Ibid. See also Douglas A Irwin, Do we need the WTO? *Cato Journal* 19 (3) 2000. One widely recognised theoretical exception to the case for unilateral liberalisation arises when a country is large enough to influence its own terms of trade.

59 In fact a significant amount of trade liberalisation in the past two decades, particularly in developing countries but also in Australia, *has* been carried out on a unilateral basis.

60 Wolf, Globalization and global economic governance. *Oxford Review of Economic Policy* 20 (1) 2004.

61 The prisoners' dilemma game is based on the following thought-experiment. The police have seized two suspects they (correctly) believe have committed a crime, but they need a confession to convict. Each is held separately and told the following: if you implicate your partner, you will be released and your partner will receive the maximum gaol time for the crime; if you say nothing and he implicates you, then he will be heading home and you will

face the gaol sentence; if you each implicate the other, you will both be sentenced to gaol but will receive reduced sentences for cooperation. The best outcome for both suspects is for them each to say nothing and both be released, while the worst outcome for each arises if they say nothing while their partner talks to the police. The most rational strategy (the 'dominant strategy') for each individual under these circumstances turns out to be for each to implicate the other; hence they both end up in gaol. The parallel with trade policy is that while the best result is that no country uses protection (equivalent to both prisoners going free), the incentive to cheat means that the likely outcome is countries follow protectionist policies (implicate the other prisoner) producing a collective outcome that is inferior to the cooperative outcome. The multilateral trading system can be seen as a mechanism designed to make the superior, cooperative outcome more likely.

62 Paul Wonnacott and Ronald Wonnacott, What's the point of reciprocal trade negotiations? Exports, imports and gains from trade. *World Economy* 28 (1) 2005. They also point out that this argument for reciprocity can also apply — but in a weaker form — to the case for PTAs.

63 Warwick J McKibbin, *Regional and multilateral trade liberalization: the effects on trade, investment and welfare*. Brookings Discussion Papers in International Economics No 134. Washington DC, Brookings Institution, 1997.

64 Wilfred J Ethier, The new regionalism. *Economic Journal* 108 1998. p 1149.

65 Rohini Acharya and Michael Daly, *Selected issues concerning the multilateral trading system*. WTO Discussion Paper No 7. Geneva, World Trade Organization, 2004. p 5. The authors point out that even in industrial countries where MFN tariff rates are low, tariffs in certain sectors remain high (so-called 'tariff peaks').

66 Ibid. pp 6–7.

67 Andrew K Rose, *Do we really know that the WTO increases trade? MAS Occasional Paper No 24.* Singapore, Monetary Authority of Singapore, 2002.

68 The explanatory factors come from the gravity model of international trade; probably the most widely used empirical method for explaining trade flows. The gravity model is based on the assumption that trade between two countries will be a positive function of economic size (measured by income and income per capita) and a negative function of economic distance (measured by geographical variables that proxy for transport costs and by quantitative measures of trade restrictions). For a discussion of the gravity model see Box 3.3 in International Monetary Fund, *World economic outlook September 2002.* Washington DC, International Monetary Fund, 2002.

69 Arvind Subramanian and Shang-Jin Wei, *The WTO promotes trade, strongly but unevenly*. IMF Working Paper. Washington DC, International Monetary Fund, 2003. For Rose's response to this paper see http://faculty.haas.berkeley.edu/arose/SWResponse.pdf [cited 1 September 2005].

70 See Patrick Low, WTO is about more than just free trade. *Financial Times*, 14 November 2002.

71 World Bank, *Global economic prospects 2005*. p 27.

72 Robert Gilpin, *The challenge of global capitalism: the world economy in the 21st century*. Princeton, Princeton University Press, 2000. p xv.

73 Paul R Krugman, The move towards free trade zones, in *Policy implications of trade and currency zones: a symposium sponsored by the Federal Reserve Bank of Kansas City*. Jackson Hole, Wyoming, 1991.

74 See for example Jagdish Bhagwati, *Free trade today.* Princeton, Princeton University Press, 2002. pp 21–22.

75 Irwin, *Free trade under fire*. pp 179–180.

76 World Trade Organization, *Trading into the future*.

77 Irwin, *Free trade under fire*. Especially pp 180–185. Chapters 1 and 2 in World Trade Organization, *Understanding the WTO*.

78 The WTO replaced GATT (the international agency) but the GATT agreement (GATT 1947) remained, albeit in a supplemented and updated form to be incorporated into the new WTO agreement. This 'new' GATT (GATT 1994) was then installed alongside the General Agreement on Trade in Services (GATS) and the agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS). World Trade Organization, *Understanding the WTO*. p 19.

79 This box is based on Chapter 2 in World Trade Organization, *Understanding the WTO*. See pp 23–24.

80 Irwin, *Free trade under fire*. pp 187–188 and Alan V Deardorff and Robert M Stern, What you should know about globalization and the World Trade Organization. *Review of International Economics* 10 (3) 2002. p 414.

81 Martin Wolf, Globalization and global economic governance. p 75. Diane Coyle, *Governing the world economy.* Cambridge, Polity, 2000. p 74.

82 Philippe Legrain, *Open world: the truth about globalisation.* London, Abacus, 2003. p 181.

83 Dani Rodrik, Free trade optimism: lessons from the battle in Seattle. *Foreign Affairs* 82 (3) 2003.

84 In the Quad for example, applied MFN tariffs on agricultural products still average more than four times those on non-agricultural products, and total support to agriculture by OECD countries was US$318 billion in 2002 (roughly the same as sub-Saharan Africa's annual GDP). Acharya and Daly, *Selected issues concerning the multilateral trading system*. pp 13–14.

85 Bernard Hoekman and Richard Newfarmer, *After Cancún: continuation or collapse?* Trade Note 13. Washington DC, World Bank, 2003. p 2. Acharya and Daly, *Selected issues concerning the multilateral trading system*. pp 10–11.

86 See for example Dilip K Das, *Global trading system: journey from Seattle to Doha*. Asia Pacific School of Economics and Management Working Papers 02-1. Canberra, Australian National University, 2002.

87 The Economist, The WTO under fire. *The Economist*, 18 September 2003.

88 Jeffrey Schott, Unlocking the benefits of world trade. *The Economist*, 30 October 2003.

89 Hoekman and Newfarmer, *After Cancún: continuation or collapse?* p 2. Other factors in play included the concerns of some African economies that liberalising agricultural trade would cost them existing preferences, while another group of African states focused on the adverse consequences of US cotton subsidies for their economies.

90 The name comes from the 1996 Singapore Ministerial Meeting at which they were originally proposed.

91 Economist, The WTO under fire.

92 Jagdish Bhagwati, Don't cry for Cancún. *Foreign Affairs* 83 (1) 2004.

93 Reported in Robert Z Lawrence, John Lipsky and James Glassman, Cancún collapse won't halt global trade reform. *Global Issues Special Edition November 2003.* New York, JP Morgan, 2003. pp 7–8. See also Robert B Zoellick, America will not wait. *Financial Times*, 21 September 2003.

94 The Economist, Now harvest it. *The Economist*, 5 August 2004.

95 Robert E Baldwin, Key challenges facing the WTO, in *Doha and beyond: the future of the multilateral trading system*. ed. Mike Moore. Cambridge, Cambridge University Press, 2004. p 46. The merits of extending trade rules into areas such as intellectual property rights remains the subject of heated debate.

96 Sutherland, Bhagwati, Botchwey, Fitzgerald, Hamada, Jackson, Lafer and de Montbrial, *The future of the WTO: addressing institutional challenges in the new millennium. Report by the Consultative Board to the Director-General Supachai Panitchpakdi*. p 61.

97 When Cambodia acceded to the WTO in 2004, in theory it enjoyed exactly the same voting rights as the vastly larger US economy, in stark contrast to the practice of other international organisations like the IMF (where Cambodia would have just 0.05% of the votes on the board of governors compared to roughly 17% for the US). See The Economist, Too soft, too open, too democratic? *The Economist*, 26 September 2003. Michele Fratianni and John Pattison argue that the relative decline of the WTO (and the parallel rise of PTAs) is a consequence of the simple proposition that cooperation is easier in smaller groups with a few larger players. Michele Fratianni and John Pattison, International organisations in a world of regional trade agreements: lessons from club theory. *World Economy* 24 (3) 2001.

98 Given the large membership, this means that in effect informal consultations play a major role in setting the organisation's agenda, with particularly difficult issues requiring side meetings of smaller groups of delegations. Historically, the major trading powers of the 'Quad' (the United States, Japan, the EU and Canada) have played a leading role in guiding decisions. See the section 'Whose WTO is it anyway?' on the WTO website at http://www.wto.org/english/thewto_e/whatis_e/tif_e/org1_e.htm [cited 31 August 2005].

99 See for example Jeffrey J Schott and Jayashree Watal, *Decision-making in the WTO*, Vol 00-2. Institute for International Economics (IIE) Policy Brief. Washington DC, Institute for International Economics, 2000. Also Baldwin, Key challenges facing the WTO. pp 48–49.

100 Stephen Roach, *Globalization at risk*. Morgan Stanley Special Economic Study, 2003.

101 Jeffrey J Schott, Free trade agreements: boon or bane of the world trading system, in *Free Trade Agreements: US strategies and priorities*. ed. Jeffrey J

Schott. Washington DC, Institute of International Economics, 2004. p 17. Hoekman and Newfarmer, *After Cancún: continuation or collapse?* p 5.

102 C Fred Bergsten, A renaissance for US trade policy? *Foreign Affairs* 81 (6) 2002.

103 Baldwin, Key challenges facing the WTO. pp 48–49.

104 For an interesting take on some of these issues see Alan V Deardorff, What might globalization's critics believe? *The World Economy* 26 (5) 2003.

105 See Andrew Stoeckel, *Termites in the basement. To free up trade, fix the WTO's foundations.* Barton, Rural Industries Research and Development Corporation (RIRDC), 2004. p xii. Stoeckel stresses that the problems with the current system are found not with the organisation (the WTO) itself but rather with the institution (the trading rules) which the WTO supports.

106 Bhagwati, *Free trade today*. p 107.

107 World Trade Organization, *Annual report 2003.* Geneva, World Trade Organization, 2003. p 26.

108 The differences between FTAs, customs unions, common markets and economic unions are set out in Box 2.1 in World Bank, *Global economic prospects 2005*.

109 See for example Andrew Stoeckel and Brent Borrell, *Preferential trade and developing countries. Bad aid, bad trade.* Barton, Rural Industries Research and Development Corporation (RIRDC), 2001.

110 Sutherland, Bhagwati, Botchwey, Fitzgerald, Hamada, Jackson, Lafer and de Montbrial, *The future of the WTO: addressing institutional challenges in the new millennium. Report by the Consultative Board to the Director-General Supachai Panitchpakdi*. p 22.

111 The 12 non-members were American Samoa, Bermuda, Channel Islands, Guam, Isle of Man, Monaco, Mongolia, Northern Mariana Islands, Palau, Puerto Rico, Timor-Leste and the Virgin Islands. World Bank, *Global economic prospects 2005*. pp 29–30 and note 2 on p 53.

112 Ibid. p 41. Note however that the Bank includes only reciprocal preferences in its calculations, excluding schemes like the GSP.

113 Sutherland, Bhagwati, Botchwey, Fitzgerald, Hamada, Jackson, Lafer and de Montbrial, *The future of the WTO: addressing institutional challenges in the new millennium. Report by the Consultative Board to the Director-General Supachai Panitchpakdi*. p 19.

114 The EEC was established by the Treaties of Rome, signed in 1957. The EEC became the European Union (EU) in 1992 after the signing of the Maastricht Treaty.

115 Ethier, The new regionalism. Schott, Free trade agreements: boon or bane of the world trading system.

116 This typology is from Richard Adams, Philippa Dee, Jyothi Gali and Greg McGuire, *The trade and investment effects of preferential trading arrangements — old and new evidence*. Staff Working Paper May 2003. Melbourne, Productivity Commission, 2003. pp 1–7.

117 World Trade Organization, *World trade report 2003*. p 51. The past decade has also brought attempts to forge 'superregional' pacts such as the Free Trade Area of the Americas (FTAA) which seek to integrate already existing trade blocs. Schott, Free trade agreements: boon or bane of the world trading system. pp 5–6.

118 On the possible welfare costs of tightening IP protection see for example David Richardson, *Intellectual property rights and the Australia–US Free Trade Agreement*. Research Paper No 14 2003–04, Economics, Commerce and Industrial Relations Section, Canberra, 31 May 2004, who cites work by the Productivity Commission indicating that in the case of a net IP importer like Australia the losses from such a move would outweigh the benefits. For a free trade economist's sceptical take on the benefits of capital mobility see Jagdish Bhagwati, The capital myth: the difference between trade in widgets and trade in dollars. *Foreign Affairs* 77 (3) 1998.

119 World Bank, *Global economic prospects 2005*. p 78 and pp 85–91. In theory efforts to lower some of these barriers need not take part within a PTA. Other forms of institutional arrangements such as APEC also seek to deliver improvements in some of these areas.

120 World Bank, *Trade blocs*. World Bank Trade Policy Research Report. New York, Oxford University Press, 2000.

121 Richard E Baldwin, A domino theory of regionalism, in *Expanding membership in the European Union*. ed. Richard E Baldwin, P Haaparanta, and J Kiander. Cambridge, Cambridge University Press, 1995. See also Richard E Baldwin, The causes of regionalism. *World Economy.* 20 (7) 1997.

122 John Whalley, Why do countries seek regional trade agreements?, in

The regionalization of the world economy. ed. Jeffrey A Frankel. Chicago, Chicago University Press, 1998.

123 The following draws on Chapter 2 in World Bank, *Trade blocs*. Also Chapter 7 in Schiff and Winters, *Regional integration and development*.

124 Trade policy can also *worsen* the security environment. For example, in the run up to the American Civil War, the industrial North wanted high tariffs while the cotton exporting South wanted cheaper imports, objecting to the massive income transfers to the North created by protectionism. World Bank, *Trade blocs*. pp 13–15

125 Implicit is the assumption that trade serves as a substitute for immigration. In fact there is some evidence to suggest that the two are complements. Schiff and Winters, *Regional integration and development*. p 197.

126 Richard E Feinberg, The political economy of United States' Free Trade Arrangements. *The World Economy* 26 (7) 2003. p 1020.

127 Europe has long been a participant in PTAs so it is harder to argue that Brussels is directly responsible for the current *acceleration* in PTA growth: the Europeans are long-term offenders. Still, the recent proliferation in PTAs, at least in a numerical sense, is certainly a reflection of the EU's trade policy.

128 Gilpin, *The challenge of global capitalism: the world economy in the 21st century*. pp 232–233. However, often the initiative for these agreements came from US trading partners, and not Washington. The US–Canada FTA was a Canadian initiative, while in the case of NAFTA, Mexico proposed FTA talks. In the past, '[m]ore often that not, the US has been a reluctant participant even in its own FTAs'. Feinberg, The political economy of United States' Free Trade Arrangements. p 1022.

129 Feinberg, The political economy of United States' Free Trade Arrangements. p 1021.

130 World Bank, *Global economic prospects 2005*. pp 31–35.

131 Greg Mastel, The rise of the free trade agreement. *Challenge*, July–August 2004. p 42.

132 World Bank, *Global economic prospects 2005*. p 136. The Bank also reaches a similar conclusion with regard to the EU.

133 J Viner, *The customs union issue.* New York, Carnegie Endowment for International Peace, 1950.

134 To illustrate this, take the hypothetical case of three economies that all produce the same product; say a CD. Assume that the cost of production is \$8 in Australia, \$6 in the US and \$4 in Korea. Assume also that Australia imposes a tariff on all CD imports to protect domestic producers. If Canberra decides to cut all barriers to trade in CDs on a multilateral basis, Australian welfare is improved by access to cheaper Korean CDs. What if instead Australia and the United States sign a PTA? There are two possibilities. If Australia's initial tariff on CDs was set at a level that excluded both Korean and US imports (say \$5 per CD), then a reduction of the tariff on US CDs would boost welfare by giving Australia access to cheaper CDs. But if the initial tariff was \$3, so that Australia was already importing Korean CDs (and the government was pocketing a \$3 tariff for each unit imported), after the PTA Australia will switch from Korean to US CDs. The PTA has introduced a distortion by diverting trade from the lowest-cost producer. Australia gains from the PTA if it is *trade-creating* (US CDs replace higher cost domestic production) but loses if it is *trade-diverting* (US CDs replace lower cost Korean ones). This example is derived from Paul R Krugman and Maurice Obstfeld, *International economics: theory and policy*, 6th ed. Boston, Addison-Wesley, 2003. pp 245–246.

135 James E Meade, *The theory of customs unions.* Amsterdam, North-Holland, 1955.

136 Richard G Lipsey, The theory of customs unions: trade diversion and welfare. *Economica* 24 (93) 1957. Lipsey's insight has been extended into the concept of 'natural trading blocs' whereby countries that already trade extensively together will be predisposed towards PTAs. While some economists argue that natural trading blocs will not create significant trade diversion the generality of this result has been questioned. See Jagdish Bhagwati, David Greenaway and Arvind Panagariya, Trading preferentially: theory and policy. *Economic Journal* 108 1998.

137 Anne O Krueger, Are preferential trading arrangements trade-liberalizing or protectionist? *Journal of Economic Perspectives* 13 (4) 1999.

138 Any net gains from trade creation could be more than offset by increased administrative costs, for example.

139 World Bank, *Global economic prospects 2005*. pp 104–105.

140 One notorious example is found in the EU's ROOs, which allow bread biscuits and pastry products to be made from imported products of any

tariff heading *except* the one that includes flour, the basic ingredient. World Bank, *Global economic prospects 2005*. p 70.

141 Ibid. pp 68–70.

142 Summers, Regionalism and the world trading system. p 296.

143 Bhagwati, *Free trade today*. p 93.

144 World Bank, *Global economic prospects 2005*. Box 3.1. Peter Lloyd and Donald MacLaren, *The case for free trade and the role of RTAs*. Seminar on regionalism and the WTO. Geneva, World Trade Organization, 2003. Schiff and Winters, *Regional integration and development*. Box 2.1.

145 Sherman Robinson and Karen Thierfelder, *Trade liberalization and regional integration: the search for large numbers.* Washington DC, International Food Policy Research Institute, 1999. p 15.

146 Organisation for Economic Co-operation and Development, *Regional integration: observed trade and other economic effects*. Paris, Working Party of the Trade Committee, Organisation for Economic Co-operation and Development, 2001. p 4.

147 Lloyd and MacLaren, *The case for free trade and the role of RTAs.* Washington DC, International Food Policy Research Institute, 1999. p 16.

148 *Ex post* studies mainly use the gravity model of international trade. As described earlier, the gravity model is based on the assumption that trade between two countries will be a positive function of size and a negative function of distance. These standard gravity model variables are assumed to determine normal trade flows and dummy variables are included to account for the effect of PTA membership. A positive dummy variable in an equation describing trade between two member economies indicates trade creation; a negative variable for trade between a member and a non-member indicates trade diversion.

149 Chapter 4 in Adams, Dee, Gali and McGuire, *The trade and investment effects of preferential trading arrangements – old and new evidence*. Organisation for Economic Co-operation and Development, *Regional integration: observed trade and other economic effects*. World Bank, *Global economic prospects 2005*. Box 3.2 and p 62. Surprisingly, Adams et al find that more comprehensive PTAs such as the Australia–New Zealand CER agreement tend to have a greater negative effect on intra-bloc trade than less comprehensive deals.

150 Organisation for Economic Co-operation and Development, *Regional trade agreements and the multilateral trading system: consolidated report*. Paris, Organisation for Economic Co-operation and Development, 20 November 2002. World Trade Organization, *World trade report 2003*.

151 Adams, Dee, Gali and McGuire, *The trade and investment effects of preferential trading arrangements — old and new evidence*. Chapter 5.

152 World Trade Organization, *World trade report 2003*.

153 Robert Z Lawrence, Emerging regional arrangements: building blocks or stumbling blocks, in *Finance and the international economy 5: the AMEX Bank Review prize essays.* ed. O'Brien. New York, Oxford University Press, 1991. Lawrence credits Jagdish Bhagwati with coining the phrase.

154 The term 'competitive liberalisation' was probably invented by Fred Bergsten. C Fred Bergsten, *Competitive liberalization and global free trade: a vision for the early 21st century*. Working Paper 96-15. Washington DC, Institute for International Economics, 1996.

155 For more on the origins of Article XXIV see Kerry A Chase. *Multilateralism compromised: the mysterious origins of GATT Article XXIV.* Tufts University 2005: http://ase.tufts.edu/polsci/faculty/chase/multilateralism.pdf [cited 20 September 2005].

156 World Bank, *Trade blocs*. p 106.

157 World Trade Organization, *Annual report 2003*. p 29.

158 Ibid. p 29.

159 World Bank, *Trade blocs*. pp 109–111.

160 Bhagwati, *Free trade today*. pp 93–95. Gresham's Law states that bad money drives out good.

161 The theoretical literature on the relationship between PTAs and the world trading system was jump-started by a seminal article by Paul Krugman. Krugman looked at a world economy where trade flows were steadily concentrated into a shrinking number of trade blocs. In his model two offsetting effects were at work: as the number of blocs shrank, so did the number of tariffs; but as each remaining bloc grew in size and market power, so did its incentive to try to move the terms of trade in its favour by increasing its external tariff. Krugman's model predicted a U-shaped relationship between the number of blocs and global welfare, with the worst number of blocs being three. Paul R Krugman, Is bilateralism bad?, in *International*

trade and trade policy. ed. Elhanan Helpman and Assaf Razin. Cambridge, MIT Press, 1991. Subsequent work has shown that this result is sensitive to the model's assumptions, and has focused on whether repeated interaction changes the outcome, given the costs (trade wars) involved in raising tariffs. The incentive for a bloc to increase its own tariff has to be set against the losses incurred in the resulting trade war. Whether fewer trade blocs mean more or less trade conflict then depends upon which effect dominates (which in turn is partly a function of the discount rate). Schiff and Winters, *Regional integration and development*. pp 261–266 and pp 225–227.

162 World Bank, *Trade blocs*. p 95. Schiff and Winters, *Regional integration and development*. pp 261–266 and p 222. L Alan Winters, Regionalism vs multilateralism, in *Market integration, regionalism and the global economy*. ed. Richard E Baldwin, et al. Cambridge, Cambridge University Press, 1999. p 7.

163 Winters, Regionalism vs multilateralism. p 7.

164 Chapter 6 takes a more detailed look at the direction and composition of Australian trade flows.

165 When all else is equal, trade tends to represent a larger share of output in smaller economies.

166 The World Bank defines manufactures as covering commodities in SITC sections 5 (chemicals), 6 (basic manufactures), 7 (machinery and transport equipment), and 8 (miscellaneous manufactured goods), excluding division 68 (non-ferrous metals). 'High tech' exports are defined as comprising products with high research and development intensity, such as in aerospace, computers, pharmaceuticals, scientific instruments and electrical machinery.

167 The term was coined by the Japanese economist Kaname Akamatsu in a series of articles written in the 1930s in Japanese, and then in articles in English in the early 1960s. It has been criticised as oversimplifying the processes involved.

168 See for example Mari Pangestu and Sudarshan Gooptu, New regionalism: options for China and East Asia, in *East Asia integrates: a trade policy agenda for shared growth*. ed. Kathie Krumm and Homi Kharas. Washington DC, World Bank, 2004. p 42.

169 Here East Asia comprises China, Japan, Hong Kong SAR, South Korea, Indonesia, Malaysia, the Philippines, Singapore and Thailand. This captures the major regional trading economies with the exception of Taiwan, which the IMF's Direction of Trade Statistics does not report as a separate item.

170 Harm Zebregs, *Intraregional trade in emerging Asia*. IMF Policy Discussion Paper April 2004. Washington DC, International Monetary Fund, 2004. pp 6–7.

171 Francis Ng and Alexander Yeats, *Major trade trends in East Asia*. World Bank Policy Research Working Paper June 2003. Washington DC, World Bank, 2003. Zebregs, *Intraregional trade in emerging Asia*. p 3. Ng and Yeats define the region to comprise Brunei, Cambodia, China, Hong Kong, Indonesia, South Korea, Laos, Malaysia, Mongolia, the Philippines, Singapore, Taiwan, Thailand and Vietnam. Zebregs uses China, Hong Kong, India, Indonesia, Korea, Malaysia, the Philippines, Singapore, Taiwan and Thailand.

172 Zebregs, *Intraregional trade in emerging Asia*. p 9. Zebregs notes that this is high compared to other developing regions. Thus the share is less than 35 % in South America and lower still in Africa and the Middle East.

173 See for example John Weiss, *People's Republic of China and its neighbours: partners or competitors for trade and investment?* ADB Institute Discussion Paper No 13. Tokyo, Asian Development Bank Institute, 2004.

174 Ng and Yeats, *Major trade trends in East Asia*. pp 19–23. Trade between two countries is judged to be 'intense' if it is greater than might be expected given the partners' share in world trade and geographic proximity.

175 Ibid. pp 23–24.

176 Ibid. p 10.

177 See for example World Trade Organization, *World trade report 2003*. p 1.

178 Box 1.1 in Asian Development Bank, *Asian development outlook 2004*. Manila, Asian Development Bank, 2004.

179 John Fernald and Prakash Loungani, *Comrades or competitors? On trade relations between China and emerging Asia*. Chicago Fed Letter March 2004. Chicago, The Federal Reserve Bank of Chicago, 2004. For one attempt to quantify the share of competing versus complementing regional exports see Economic Analytical Unit, *China's industrial rise: East Asia's challenge*. Canberra, Department of Foreign Affairs and Trade, 2003.

180 A significant share of Japanese exports to China is subsequently re-exported to the United States.

181 According to one Japanese official 'I look at the semiconductor industry, where Japan took everything it needed in terms of technology from America, forcing that sector into virtual extinction … Now we are getting payback. China is going to do the same thing to us.' Quoted in David Pilling and Richard McGregor, Crossing the divide. *Financial Times*, 29 March 2004.

182 World Bank, *East Asia update.* Washington DC, World Bank, 2004. p 13.

183 Joe Studwell, China will not pay for Southeast Asia's lunch. *Financial Times*, 5 July 2004.

184 This question is posed in Warwick J McKibbin and Wing Thye Woo, The consequences of China's WTO accession on its neighbors. *Asian Economic Papers* 2 (2) 2003.

185 World Trade Organization, *World trade report 2004.* Geneva, World Trade Organization, 2004. p 1.

186 Chung H Lee and Michael G Plummer, *Economic development in China and its implications for East Asia*. University of Hawaii Working Paper No 04-11. Manoa, University of Hawaii, 2004.

187 Elena Ianchovichina, Sethaput Suthiwart-Narueput and Min Zao, Regional impact of China's accession to the WTO, in *East Asia integrates: a trade policy agenda for shared growth*. eds. Kathie Krumm and Homi Kharas. Washington DC, World Bank, 2004. pp 26–27. See also Elena Ianchovichina and Terrie Walmsley, *Impact of China's WTO accession on East Asia*. World Bank Policy Research Working Paper 3109. Washington DC, World Bank, 2003. And Elena Ianchovichina and William J Martin, *Economic impacts of China's accession to the WTO*. World Bank Policy Research Working Paper 3053. Washington DC, World Bank, 2003. Eichengreen et al reach broadly positive conclusions on the relationship between Chinese and regional exports. Barry Eichengreen, Yeongseop Rhee and Hui Tong, *The impact of China on the exports of other Asian countries.* NBER Working Paper No 10768, Cambridge MA, National Bureau of Economic Research, 2004.

188 Ianchovichina, Suthiwart-Narueput and Zao, *Regional impact of China's accession to the WTO*. pp 22–25. McKibbin and Woo point out that WTO membership removed Beijing's reliance on annual approval from the US Congress for MFN. By reducing China's vulnerability to swings in US political sentiment, this should have lowered the risk premium required

to invest in China. McKibbin and Woo, *The consequences of China's WTO accession on its neighbors*.

189 McKibbin and Woo, *The consequences of China's WTO accession on its neighbors*.

190 Eichengreen and Tong provide some evidence for this hypothesis. Barry Eichengreen and Hui Tong, *Is China's FDI coming at the expense of other countries?* NBER Working Paper No 11335. Cambridge MA, National Bureau of Economic Research, 2005.

191 See the Introduction to Edward J Lincoln, *East Asian economic regionalism.* Washington DC, The Brookings Institution, 2004. Francis Fukuyama has also pointed to the emergence of various multilateral economic forums in the region. Francis Fukuyama, Re-envisioning Asia. *Foreign Affairs* 84 (1) 2005.

192 C Fred Bergsten, Towards a tripartite world. *The Economist*, 13 July 2000.

193 Barry Eichengreen, Hanging together? On monetary and financial cooperation, in *Global change and East Asian policy initiatives*. eds. Shahid Yusuf, M Anjum Altaf and Kaoru Nabeshima. Washington DC, World Bank, 2004. pp 25–27. Shahid Yusuf, M Anjum Altaf, Barry Eichengreen, Sudarshan Gooptu, Kaoru Nabeshima, Charles Kenny, Dwight H Perkins and Marc Shotten, *Innovative East Asia: the future of growth.* Washington DC, World Bank, 2003. pp 95–96.

194 The number is two if Australia and New Zealand — the members of CER — are counted as part of the region. Robert Scollay, The changing outlook for Asia–Pacific regionalism. *The World Economy* 24 (9) 2001.

195 A theoretical regional PTA covering Australia, New Zealand, Singapore, Chile and the United States.

196 Jong-Wha Lee and Innwon Park, Free trade areas in East Asia: discriminatory or non-discriminatory. *World Economy* 28 (1) 2005. p 21 and Yusuf, Altaf, Eichengreen, Gooptu, Nabeshima, Kenny, Perkins and Shotten, *Innovative East Asia: the future of growth*. pp 97–100.

197 Arguably NAFTA has shown that regional trade agreements are workable even given substantial differences in development levels. But income diversity in ASEAN is greater than in NAFTA, and ASEAN economies have more diverse development models than do NAFTA members. Yusuf, Altaf, Eichengreen, Gooptu, Nabeshima, Kenny, Perkins and Shotten, *Innovative East Asia: the future of growth*. pp 127–128.

198 Robert Scollay and John P Gilbert, *New regional trading arrangements in the Asia Pacific?* Policy Analyses in International Economics. Washington DC, Institute for International Economics, 2001. pp 2–3.

199 World Trade Organization, *Annual report 2001.* Geneva, World Trade Organization, 2001.

200 The Economist, Noodle soup. *The Economist Global Agenda*, 8 October 2003.

201 Pangestu and Gooptu, *New regionalism: options for China and East Asia*. p 39.

202 Under the 'flying geese' model of regional trade described earlier, the region's economies tended to specialise in different industries and products, making a regional approach to trade liberalisation likely to produce more trade diversion than trade creation. So the recent integration of East Asian economies into regional supply chains may have made freer trade on a regional basis more attractive, by creating a greater presumption that regional trade liberalisation will tend to be more trade-creating. Yusuf, Altaf, Eichengreen, Gooptu, Nabeshima, Kenny, Perkins and Shotten, *Innovative East Asia: the future of growth*. p 122.

203 Pangestu and Gooptu, New regionalism: options for China and East Asia. Charles Harvie and Hyun-Hoon Lee, New regionalism in East Asia: how does it relate to the East Asian economic development model? *ASEAN Economic Bulletin* 19 (2) 2002. Asian Development Bank, Preferential trade agreements in Asia and the Pacific, in *Asian development outlook 2002, special chapter.* Manila, Asian Development Bank, 2002.

204 See Rawdon Dalrymple, *Continental drift: Australia's search for a regional identity.* Sydney, Ashgate Publishing Limited, 2003.

205 It is often claimed that Japan's pursuit of an FTA with Mexico reflected fears that Japanese companies were being squeezed out of the lucrative US market.

206 Bergsten, Towards a tripartite world.

207 Developments in individual economies have also played a role, including Japan's quest to regain a regional leadership role and South Korean moves towards a more liberal economic system. Lee and Park, Free trade areas in East Asia: discriminatory or non-discriminatory. pp 21–22.

208 Scollay and Gilbert, *New regional trading arrangements in the Asia Pacific?* pp 7–9.

209 Bergsten, Towards a tripartite world. Bergsten also characterises APEC as in part a response to then Prime Minister of Malaysia Mahathir's proposed East Asian Economic Group.

210 APEC. *APEC economic leaders' declaration of common resolve, Bogor, Indonesia, 15 November 1994.* APEC Secretariat 1994: http://www.apecsec.org.sg/apec/leaders__declarations/1994.html [cited 2 September 2005]. The same declaration includes a call to find ways to improve consistency between existing regional PTAs (NAFTA, AFTA and the CER).

211 See Scollay, The changing outlook for Asia–Pacific regionalism. pp 1136–1143. Richard E Feinberg, Comparing regional integration in non-identical twins: APEC and the FTAA. *Integration and Trade* 4 (10) 2000. pp 18–20. Victor Mallet, A 'curious beast' faces series of challenges. *Financial Times*, 19 November 2004.

212 APEC. *One community, our future: 12th APEC economic leaders' meeting Santiago declaration, Santiago de Chile, 20–21 November 2004.* APEC Secretariat 2004: http://www.apecsec.org.sg/apec/leaders__declarations/2004.html [cited 2 September 2005].

213 Eisuke Sakakibara and Sharon Yamakawa, Trade and foreign direct investment: a role for regionalism, in *Global change and East Asian policy initiatives*. eds. Shahid Yusuf, M Anjum Altaf, and Kaoru Nabeshima. Washington DC, World Bank, 2004. p 63.

214 Joseph Yu-Shek Cheng, The ASEAN–China Free Trade Area: genesis and implications. *Australian Journal of International Affairs* 58 (2) 2004. p 258.

215 A series of articles in the *Far Eastern Economic Review* in 2003 made this case. See Michael Vatikiotis and Murray Hiebert, How China is building an empire. *Far Eastern Economic Review*, 20 November 2003. Michael Vatikiotis and David Murphy, Birth of a trading empire. *Far Eastern Economic Review*, 20 March 2003. Michael Vatikiotis and Murray Hiebert, China's tight embrace. *Far Eastern Economic Review*, 17 July 2003.

216 This argument is advanced in Agata Antkiewicz and John Whalley, *China's new regional trade agreements*. NBER Working Paper No 10992. Cambridge MA, National Bureau of Economic Research, 2004. They note that China's existing agreements tend to be more diverse than (say) European ones, making any subsequent emergence of a coherent trade bloc problematic, as well as more traditional, with the main focus on tariff reduction for manufactured products.

217 Cheng, The ASEAN–China Free Trade Area: genesis and implications. p 273.

218 Negotiations for an ASEAN–China FTA (ACFTA) first got under way in 2001. China and ASEAN signed an agreement on trade in goods in November 2004, with implementation due to take effect in July 2005. The agreement is to be followed by others covering trade in services and investment. Under the early harvest agreement (or program) the two sides agreed to implement initial tariff cuts on farm products in eight categories with effect from January 2004, with tariffs to be completely removed within three years.

219 Effective implementation after the negotiations is clearly a key area. For example, in the case of the Thai–China bilateral deal's early harvest agreement, the Thai side has complained that commitments made by Beijing have not been honoured or even heard of by Chinese customs agents at the border. Shawn Donnan and Amy Kazmin, ASEAN touts China trade deal as great leap forward. *Financial Times*, 29 November 2004.

220 Cheng, The ASEAN–China Free Trade Area: genesis and implications. pp 264–265. Later and less developed ASEAN members were given a staggered start date.

221 Guy de Jonquieres, China takes over the driving seat. Financial Times, 19 November 2004. The Economist, More effort needed. *The Economist*, 29 July 2004.

222 World Trade Organization, *World trade report 2003*. pp 54–55.

223 The Economist, Every man for himself. *The Economist*, 31 October 2002.

224 Peter Lloyd, New bilateralism in the Asia–Pacific. *World Economy* 25 (9) 2002. p 1285.

225 Pangestu and Gooptu, New regionalism: options for China and East Asia.

226 See Lloyd and MacLaren, *The case for free trade and the role of RTAs*. pp 12–16. Also Lee and Park, Free trade areas in East Asia: discriminatory or non-discriminatory. It is not always the case that non-members lose out. For example McKibbin, Lee and Cheong find that a Japan–Korea FTA would increase real GDP in Europe and China. Warwick J McKibbin, Jong-Wha Lee and I Cheong, A dynamic analysis of a Korea–Japan free trade area: simulations with the G-Cubed Asia–Pacific Model. *International Economic Journal* 18 2004.

227 Scollay and Gilbert, *New regional trading arrangements in the Asia Pacific?* pp 120–126. See also John Gilbert, Robert Scollay and Bijit Bora, New regional trading developments in the Asia–Pacific region, in *Global change and East Asian policy initiatives*. eds. Shahid Yusuf, M Anjum Altaf and Kaoru Nabeshima. Washington DC, World Bank, 2004. pp 135–143. In contrast to the results generated by these CGE models, Lee and Park use an approach based on the gravity model which finds that the effect of regional PTAs is trade-creating for members *without* significant adverse effects on non-members. Lee and Park, Free trade areas in East Asia: discriminatory or non-discriminatory. pp 35–41.

228 Bergsten, Towards a tripartite world.

229 Scollay, The changing outlook for Asia–Pacific regionalism. p 1151. Scollay and Gilbert, *New regional trading arrangements in the Asia Pacific?* p 56.

230 David Lague and Trish Saywell, A growing storm for East Asia. *Far Eastern Economic Review*, 17 May 2001. Jonquieres, China takes over the driving seat.

231 Figure 6.1 is plotted using constant prices. A current price ratio would show that Australia today is still less integrated with the global economy than it was in 1949/50. One explanation for this difference is that today GDP is dominated by services, which tend to be less traded than goods. Since at the same time there has been a fall in the price of goods relative to services, this leads to the different trends in the two ratios.

232 Simon Guttman and Anthony Richards, Australia's trade openness. *Reserve Bank Bulletin March* 2005.

233 Department of Foreign Affairs and Trade, *Trade in services 2003–04.* Canberra, Department of Foreign Affairs and Trade, 2005. pp 15–18. The numbers on sales revenue refer to foreign affiliates which are majority Australian owned.

234 Ibid. p 11.

235 For example, China is estimated to have accounted for roughly half the world increase in demand for metals in 2004.

236 David Meredith and Barrie Dyster, *Australia in the global economy: continuity and change.* Cambridge, Cambridge University Press, 1999. pp 138–140.

237 Ann Capling, *Australia and the global trade system: from Havana to Seattle.* Cambridge, Cambridge University Press, 2001. p 15.

238 Ibid. p 16.

239 The CER was the latest in a series of agreements with New Zealand, beginning with the 1922 *New Zealand Preference Act* and including the New Zealand–Australia Free Trade Agreement, signed in 1965.

240 Ross Garnaut, An Australia–United States free trade agreement. *Australian Journal of International Affairs* 56 (1) 2002.

241 Ninety-six per cent of Australia's tariff lines were bound by 2002, with the average MFN tariff at 4.3 %, comprising an average applied MFN tariff in agriculture of just 1.2 % and in industry of 4.7 %. The latter reflected tariff peaks on PMV and TCF. World Trade Organization, *Trade policy review: Australia.* Geneva, World Trade Organization, 2002. Tariffs for PMV and TCF have been frozen since 2000, and are due to decline in 2005 and then again in 2010. Productivity Commission, *Trade and assistance review 2003–2004*. Annual Report Series. Canberra, AusInfo, 2004.

242 David Gruen and Glenn Stevens, *Australian macroeconomic performance and policies in the 1990s* (paper presented at the Reserve Bank of Australia 2000 conference: the Australian economy in the 1990s, Sydney, 2000).

243 As well as the CER Australia is also a member of three other PTAs: the Canada–Australia Trade Agreement, the Papua New Guinea–Australia Trade and Commercial Relations Agreement and the South Pacific Regional Trade and Economic Cooperation Agreement. Australia has also offered preferences to developing countries under the GSP. Only the CER and the Canada–Australia agreement are reciprocal agreements (and the coverage of the latter is limited). See Productivity Commission, *Trade and assistance review 2003–2004*. p 4.5.

244 See Ann Capling, *All the way with the USA: Australia, the US and free trade.* Sydney, UNSW Press, 2005. p 20 and pp 42–43. Also Chapter 8 in Capling, *Australia and the global trade system: from Havana to Seattle*.

245 Department of Foreign Affairs and Trade, *In the national interest: Australia's foreign and trade policy White Paper.* Canberra, Department of Foreign Affairs and Trade (Commonwealth of Australia), 1997. p 42.

246 Department of Foreign Affairs and Trade, *Advancing the national interest: Australia's foreign and trade policy White Paper.* Canberra, Department of Foreign Affairs and Trade (Commonwealth of Australia), 2003. pp 58–59.

247 See for example Ross Garnaut, *Effects of a free trade agreement with the United States on Australia's multilateral and regional interests* (paper presented at the Conference on an Australia–United States Free Trade Agreement, Canberra, 30 August 2002).

248 For one take on some of these criticisms see Mark P Thirlwell, *The good, the bad and the ugly: assessing criticism of the Australia–United States Free Trade Agreement*. Lowy Institute Perspectives. Sydney, Lowy Institute for International Policy, 2004. This section draws on that earlier paper.

249 See note 61 for an outline of the prisoners' dilemma game. During the AUSFTA debate Peter Lloyd made the point that participation in PTAs can be seen as a defensive for a country that cannot substantially influence what happens at the multilateral level. Peter Lloyd, *Australia's economic diplomacy in Asia*. Melbourne Asia Policy Papers Number 3. Melbourne, University of Melbourne, 2003.

250 Ross Garnaut, *Australian security and free trade with America* (paper presented at the Australian Business Economists meeting on US and Australian Free Trade Agreement: national interest or vested interest? Sydney, 27 February 2003).

251 Ross Garnaut, Discussion, in *Changing utterly? Australia's international policy in an uncertain age*. ed. William Tow. Sydney, Lowy Institute for International Policy, 2004. p 132.

252 As noted earlier, this is not to say that negotiations cannot deliver worthwhile gains to the smaller country; indeed, it is quite possible that in relative terms the smaller partner may gain more.

253 See Leon Berkelmans, Lee Davis, Warwick J McKibbin and Andrew Stoeckel, *Economic impacts of an Australia–United States Free Trade Area: CIE report for the Australian Department of Foreign Affairs and Trade*. Canberra, Centre for International Economics, 2001.

254 Centre for International Economics, *Economic analysis of AUSFTA: impact of the bilateral free trade agreement with the United States: prepared for Department of Foreign Affairs and Trade.* Centre for International Economics 2004: http://www.thecie.com.au/publications/CIE-economic_analysis_ausfta.pdf [cited 19 September 2005]. This report was a sequel to an earlier report produced before the final details of the agreement had been settled. Berkelmans, Davis, McKibbin and Stoeckel, *Economic impacts of an Australia–United States Free Trade Area: CIE report for the Australian Department of Foreign Affairs*

and Trade. The CIE used two models to estimate the effects of AUSFTA: a dynamic model (G-Cubed) and a static model (GTAP). The G-Cubed model was intended to capture the dynamic effects of AUSFTA on investment and accumulation, while the more disaggregated GTAP model was to capture sectoral detail. The G-Cubed results gave the biggest numbers for the increase in Australian welfare, with the largest share of the gains due to investment liberalisation. Some critics have argued that the G-Cubed model was too aggregated to be used to capture the effects of a PTA agreement. See for example Philippa Dee, *The Australia–US Free Trade Agreement: an assessment: paper prepared for the Senate Select Committee on the Free Trade Agreement between Australia and the United States.* 2004: http://www.aph.gov.au/Senate/committee/freetrade_ctte/rel_links/dee_fta_report.pdf [cited 19 September 2005]. p 27.

255 Using the GTAP model the CIE estimated that AUSFTA would boost Australian exports to the United States by around A$3.35 billion, while total exports would increase by $2.77 billion, since some $582 million of the former would come from the diversion of Australian exports from other markets. Similarly, imports from the United States were projected to rise by A$6.52 billion, and total Australian imports by only $2.82 billion, implying trade diversion to the tune of A$3.7 billion, with 60 % of the post-AUSFTA increase in US imports to Australia coming at the expense of other countries. (The CIE judged that the main victims would be exporters in the EU and North Asia.) In net dollar terms, AUSFTA was estimated to be trade-creating, with total trade projected to increase by $5.58 billion. Tables 7.3 and 7.4 in Centre for International Economics. *Economic analysis of AUSFTA: impact of the bilateral free trade agreement with the United States: prepared for Department of Foreign Affairs and Trade.* pp 89–90.

256 Table 7.1 in Ibid. See pp 96–98 for sensitivity analysis. The results quoted here are the (lower) numbers based on the GTAP simulations.

257 Dee, *The Australia–US Free Trade Agreement: an assessment: paper prepared for the Senate Select Committee on the Free Trade Agreement between Australia and the United States.* p 35.

258 In the automotive sector (the other sensitive sector) the CIE reported discussions with the Federal Chamber of Automotive Industries and the Federation of Automotive Products Manufacturers indicating that the

sector felt that Australian exports would be able to meet the ROOs. Centre for International Economics. *Economic analysis of AUSFTA: impact of the bilateral free trade agreement with the United States: prepared for Department of Foreign Affairs and Trade.* pp 52–53.

259 The Productivity Commission was established in 1998. It is the Australian government's main advisory body on aspects of microeconomic reform and its statutory functions include holding public inquiries and reporting on matters relating to industry and productivity.

260 Productivity Commission, *Trade and assistance review 2003–2004*. pp 4.18–4.20. In contrast, AUSFTA applies relatively liberal ROOs to services. Centre for International Economics, *Economic analysis of AUSFTA: impact of the bilateral free trade agreement with the United States: prepared for Department of Foreign Affairs and Trade.* p 16.

261 This was over and above the adjustments that the CIE made for ROOs' specific impact on Australian textile and clothing exports. Dee, *The Australia-US Free Trade Agreement: an assessment: paper prepared for the Senate Select Committee on the Free Trade Agreement between Australia and the United States.* p 34. The proposition that the ROOs utilised by AUSFTA are more restrictive than (for example) those used by the CER has been challenged. See Department of Foreign Affairs and Trade. *Supplementary submission to the Senate Select Committee on the free trade agreement between Australia and the United States of America.* 2004: http://www.aph.gov.au/Senate/committee/freetrade_ctte/submissions/sub161b.pdf [cited 30 August 2005]. This argues that the change of tariff classification approach generally followed by AUSFTA is simpler to administer than the CER ROOs. See pp 9–10 of the submission.

262 Andrew Stoler notes that companies expected gains from AUSFTA in terms of enhanced movement of personnel, the elimination of duplicate product testing, the potential rationalisation of existing labelling requirements, and a more secure environment for investment and capital flows. Andrew L Stoler, Australia–USA free trade: benefits and costs of an agreement, in *Free trade agreements: US strategies and priorities*. ed. Jeffrey J Schott. Washington DC, Institute for International Economics, 2004. p 113.

263 Centre for International Economics. *Economic analysis of AUSFTA: impact of the bilateral free trade agreement with the United States: prepared*

for Department of Foreign Affairs and Trade. p 34 and p 78. Dee, *The Australia–US Free Trade Agreement: an assessment: paper prepared for the Senate Select Committee on the Free Trade Agreement between Australia and the United States.* p 30.

264 David Richardson, *Intellectual property rights and the Australia–US Free Trade Agreement*.

265 See for example Alexander Downer, *The strategic importance of a Free Trade Agreement to Australia–United States relations* (paper presented at the Australian APEC Studies Centre conference on the impact of an Australian–United States Free Trade Agreement: Foreign Policy Challenges and Economic Opportunities, Canberra, 29 August 2002).

266 Ivan Cook, *Australians speak 2005: public opinion and foreign policy*. The Lowy Institute Poll. Sydney, Lowy Institute for International Policy, 2005.

267 Ross Garnaut, *Contemporary challenges for Australia in the international economy.* Lowy Institute for International Policy 2004: http://www.lowyinstitute.org/Publication.asp?pid = 243 [cited 5 September 2005].

268 See for example Capling, *All the way with the USA: Australia, the US and free trade*. The concluding chapter of Capling's book is called 'The death of trade policy'.

269 Although one possibility is that the WTO is effectively reduced to a sort of global baseline for trade agreements that PTAs then build upon. See Mastel, The rise of the free trade agreement. pp 44–45.

270 See for example the debate between Brzezinski and Mearsheimer. Zbigniew Brzezinski and John Mearsheimer, Debate: clash of the titans. *Foreign Policy*, January/February 2005.

271 Bhagwati has emphasised the relative paucity of resources available to the WTO's director-general. Jagdish Bhagwati, Reshaping the WTO. *Far Eastern Economic Review*, Jan/Feb 2005.

272 Jeffrey Schott for example puts the case for procedural reform to reinforce the consensus building process, and for the provision of more support to developing countries to help with the implementation burden implied by the single undertaking. Schott, Unlocking the benefits of world trade.

273 Sutherland, Bhagwati, Botchwey, Fitzgerald, Hamada, Jackson, Lafer and de Montbrial, *The future of the WTO: addressing institutional challenges in the new millennium. Report by the Consultative Board to the Director-General Supachai Panitchpakdi*. p 64. The report also points out that while there may be few concrete examples of a popular initiative being blocked, the fact that consensus is a requirement can lead members to refrain from raising an issue if they know in advance that consensus will not be achieved.

274 Ibid. pp 65–67. There is a distinction to be made here between WTO negotiations on rules and those on market access. The former apply to all members, while access negotiations are *already* plurilateral in the sense that WTO members take part at quite different levels.

275 See for example Hoekman and Newfarmer, *After Cancún: continuation or collapse?* p 8.

276 For example the role of the FIPs (that is, Brazil, India, Australia, the EU and US), in putting together a deal in agriculture to keep the Doha Round going has been criticised by some NGOs as adding to the WTO's 'democratic deficit'.

277 The need for transparency and dialogue with civil society is discussed in Chapter 5 of the consultative board's report, while Chapter 6 touches on the role of *amicus curiae* briefs. The report also notes issues relating to the transparency and accountability of some of the WTO's NGO critics. Sutherland, Bhagwati, Botchwey, Fitzgerald, Hamada, Jackson, Lafer and de Montbrial, *The future of the WTO: addressing institutional challenges in the new millennium. Report by the Consultative Board to the Director-General Supachai Panitchpakdi.*

278 Stoeckel suggests an augmented role for the Trade Policy Review Mechanism to carry out economy-wide analysis of the costs and benefits of trade policy in an effort to boost transparency and convince voters of the benefits of lower trade barriers. Stoeckel, *Termites in the basement. To free up trade, fix the WTO's foundations*. pp 89–93.

279 For the sake of consistency any changes should also cover the non-reciprocal preferences granted to developing countries. For one set of suggestions on how the existing rules governing PTAs could be improved see World Bank, *Trade blocs*.

280 Sutherland, Bhagwati, Botchwey, Fitzgerald, Hamada, Jackson, Lafer and de Montbrial, *The future of the WTO: addressing institutional challenges in the new millennium. Report by the Consultative Board to the Director-General Supachai Panitchpakdi*. p 22.

281 World Bank, *Global economic prospects 2005*. p 144.

282 For this and other suggestions see Jeffrey J Schott, Assessing US FTA policy, in *Free Trade Agreements: US Strategies and Priorities*. ed. Jeffrey J Schott. Washington DC, Institute for International Economics, 2004. pp 18–19.

283 John Edwards has argued that Australia needs to recognise the 'very grave threat presented by an accelerating trend towards free trade agreements within East Asia. The trend may well present the greatest peril to the foundations of Australian prosperity in decades.'[284] John Edwards, Australia's changing economic environment, in *Changing utterly? Australia's international policy in an uncertain age*. ed. William Tow. Sydney, Lowy Institute for International Policy, 2004. pp 63–64.

285 Bernard Gordon has argued that the current US policy of using PTAs could undermine its interests in East Asia by encouraging the construction of a political and strategic counterweight in the region. Bernard K Gordon, A high-risk trade policy. *Foreign Affairs* 82 (4) 2003.

286 APEC continues to do useful work in terms of trade and investment facilitation measures, and proposals by ABAC to upgrade these initiatives could deliver important gains in terms of regional integration. See ABAC Australia, *A 'single market agenda' for Asia–Pacific*, ABAC, 2004.

287 See Robert Scollay, *Preliminary assessment of the proposal for a free trade area of the Asia–Pacific (FTAAP). An issues paper for the APEC business advisory council (ABAC)*. ABAC 2004: http://www.apec.org.au/koreapapers2/SX-RS-Paper.pdf [cited 7 September 2005].

288 C Fred Bergsten, *Toward a Free Trade Area of the Asia Pacific* (paper presented at the APEC CEO Summit, Santiago, Chile, 19 November 2004).

289 See for example Guy de Jonquieres, Talkshop in search of a new direction. *Financial Times*, 16 October 2001.

290 John Edwards has made the case for aiming at APEC level agreements for trade liberalisation. Ross Garnaut has listed some of the potential difficulties, including the well-known reluctance of Japan and Korea to talk about substantial agriculture liberalisation, the big differences in ROOs across currently existing agreements, and the significant political-economy obstacles. Edwards, Australia's changing economic environment. pp 65–66. Garnaut, Discussion. p 132.

291 APEC, *Best practice for RTAs/FTAs in APEC: agenda item: v 2, 16th APEC Ministerial Meeting, Santiago, Chile, 17–18 November 2004*. APEC 2004: http://www.apec.org/etc/medialib/apec_media_library/downloads/ministerial/annual/2004.Par.0004.File.tmp/04_amm_003.pdf [cited 5 September 2005].

292 Ross Garnaut has made some interesting suggestions here. He has proposed that Australia consider structuring future PTAs around the idea of an Open Trade Arrangement (OTA). This would use the simplest and most liberal ROOs available, and would extend membership to any country agreeing to meet the conditions of the agreement. See Garnaut, *Contemporary challenges for Australia in the international economy*. Also Ross Garnaut, *A new open regionalism in the Asia Pacific* (paper presented at the International conference on world economy, Colima, Mexico, 2004).

293 See Department of Foreign Affairs and Trade, *Free trade agreements: Australia's approach*. http://www.dfat.gov.au/trade/negotiations/australias_approach.html [cited 5 September 2005].

294 Peter Gallagher, Too many FTAs spoil regional broth. *Australian Financial Review*, 2 August 2004.

295 This is advanced as a practical rule of thumb. Theoretically, the fact that existing bilateral flows are substantial is not on its own an argument for providing further impetus: current flows may be a product of existing distortions in the direction of trade.

296 Ashton Calvert, *Opening speech* (paper presented at the Australia–China FTA conference, Sydney, 12–13 August 2004).

297 Ann Capling, for example, worries that the current switch to PTAs has reversed the previous stance under which 'economic aims have always been paramount in determining Australian trade policy, and political or strategic objectives have not figured strongly'. Capling, *All the way with the USA: Australia, the US and free trade*. pp 8–9 and p 83.

298 World Bank, *Global economic prospects 2005*. Schott, Assessing US FTA policy. p 364.

299 Realists would argue that this would happen regardless, but tying trade policy to foreign policy presumably makes it more likely.

300 See Schiff and Winters, *Regional integration and development*. pp 75–77. They term the process 'additive regionalism'.

301 Productivity Commission, *Trade and assistance review 2003–2004*. Box 4.9. p 4.21.

302 In the aftermath of AUSFTA it might be charged that this is shutting the stable door after the horse has bolted.

303 Andrew L Stoler, Australia–USA Free Trade: Competitive liberalisation at work in 2003. *Agenda* 10 (4) 2003. p 305.

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