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Session 1: Things to know before doing impact assessment of FTAs

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Outline



- Why do countries liberalize trade?
- Approaches to trade liberalization
- Potential costs and benefits of joining an FTA
- Rules of origin
- Factors affecting utilization of FTAs
- An overview of impact assessment methods





Why do countries liberalize trade?



What is trade liberalization all about?



- Reduced barriers to trade
- Extension of trade liberalization to markets other than goods:
 - Services
 - Financial



Primary (static) gains from free trade



- Efficient structural adjustment: the country uses its resources in the most productive way when it specializes in the areas in which it has comparative advantages
 - Firms are able to source the most cost-effective inputs
 - Consumers are able to purchase imports at the lowest price
- NOTE: “free trade” and “free trade area” are not the same thing.



and dynamic gains



- **Dynamic effects:** more important but difficult to quantify
- Economies of scale: the average cost
 - The “average” cost reduction effect
 - More competitive not only at home but also in foreign markets
- Technology transfer and FDI
 - Long-term, risk-sharing investment flows
 - MNCs provide a channel to reach the global market
 - Technology transfer from MNCs
- Stimulating competition
- Structural policy change and reform
 - Pressure to embrace “best practices”, to reform law and regulations, policy harmonization.





Approaches to trade liberalization



Policy options



- UNILATERAL (non-negotiated, non-reciprocal)
- MULTILATERAL (WTO)
 - PLURILATERAL
- REGIONAL (sub-regional blocs e.g. SAFTA)
- BILATERAL



Why FTAs? Many reasons



- Economic motives:
- Minimizing beggar-thy-neighbour
- Gaining credibility
- Market access
- Other reasons:
 - increasing policy predictability
 - signalling openness to investors
 - foreign policy
- ...



Why do WTO members still need FTAs?



- It is easier to address deeper integration in a shorter period of time than via WTO
 - A requirement of “substantially all trade” in GATT/WTO
 - A group of like-minded countries
- Training ground for all – negotiators, legislators, producers, consumers
- Increased bargaining power in WTO, though trade interests of all members may not be the same



Is discrimination allowed in the multilateral trading system?



- GATT (1947) → WTO (1995)
- Both based on **MOST-FAVoured NATION (MFN)** principle: **non-discrimination** — treating virtually everyone equally
- The mutual exchange of trade concessions through instrument of “**preferential trade agreements (PTAs)**” is allowed:
 - Article XXIV of GATT 1994 provides the rules governing free trade in goods.
 - Article V of the General Agreement on Trade in Services (GATS) gives the corresponding rules for free trade in services.



The WTO and FTAs: Requirements



- Trade barriers against non-members “must not be raised”
- The FTA must be formed “within a reasonable length of time”
- The FTA must eliminate trade barriers on “substantially all the trade” among the members
- With regard to services, the General Agreement on Trade in Services (GATS) requires that the FTA or CU involve “substantial sectoral coverage”





Potential costs and benefits of joining an FTA



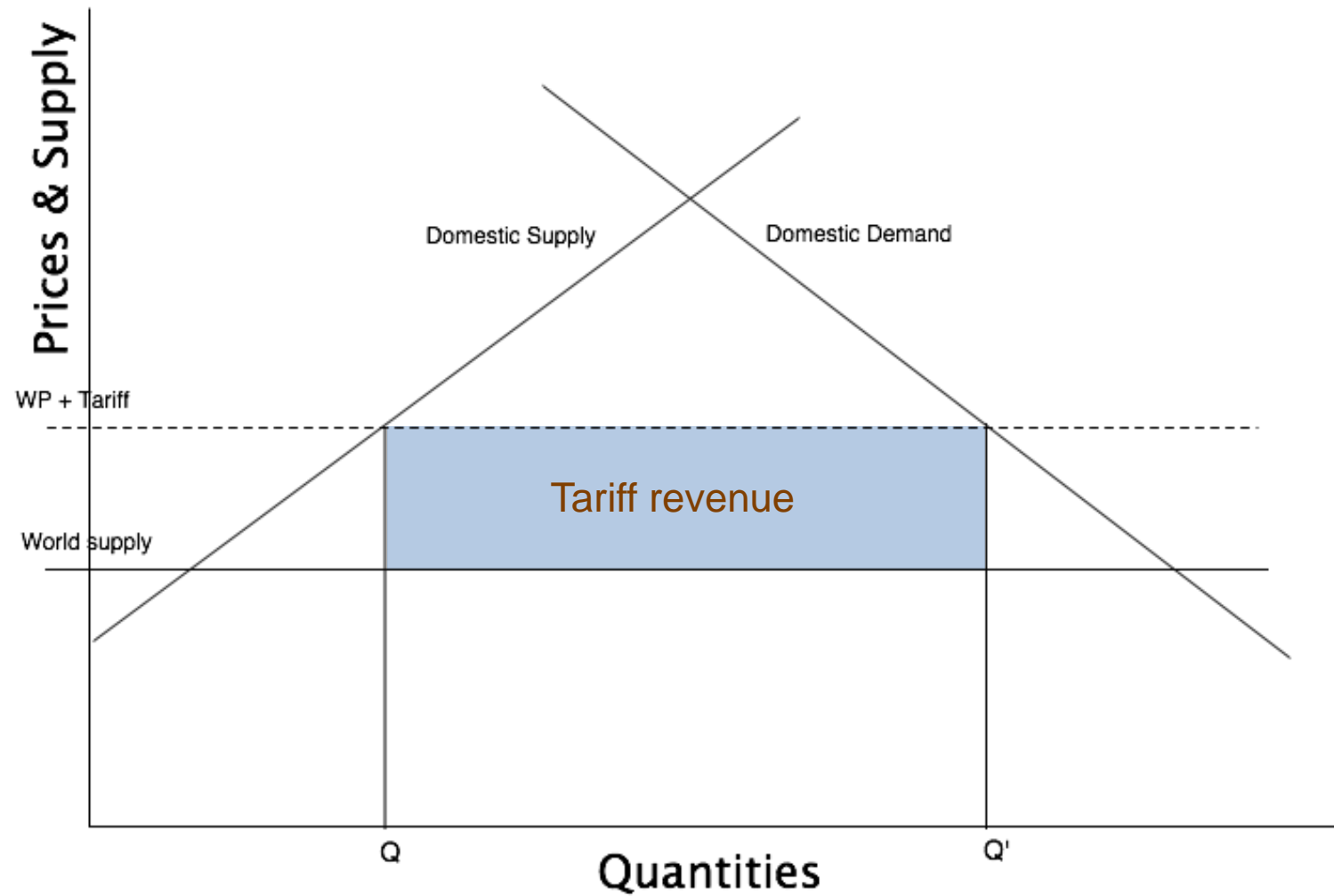
Viner Theorem

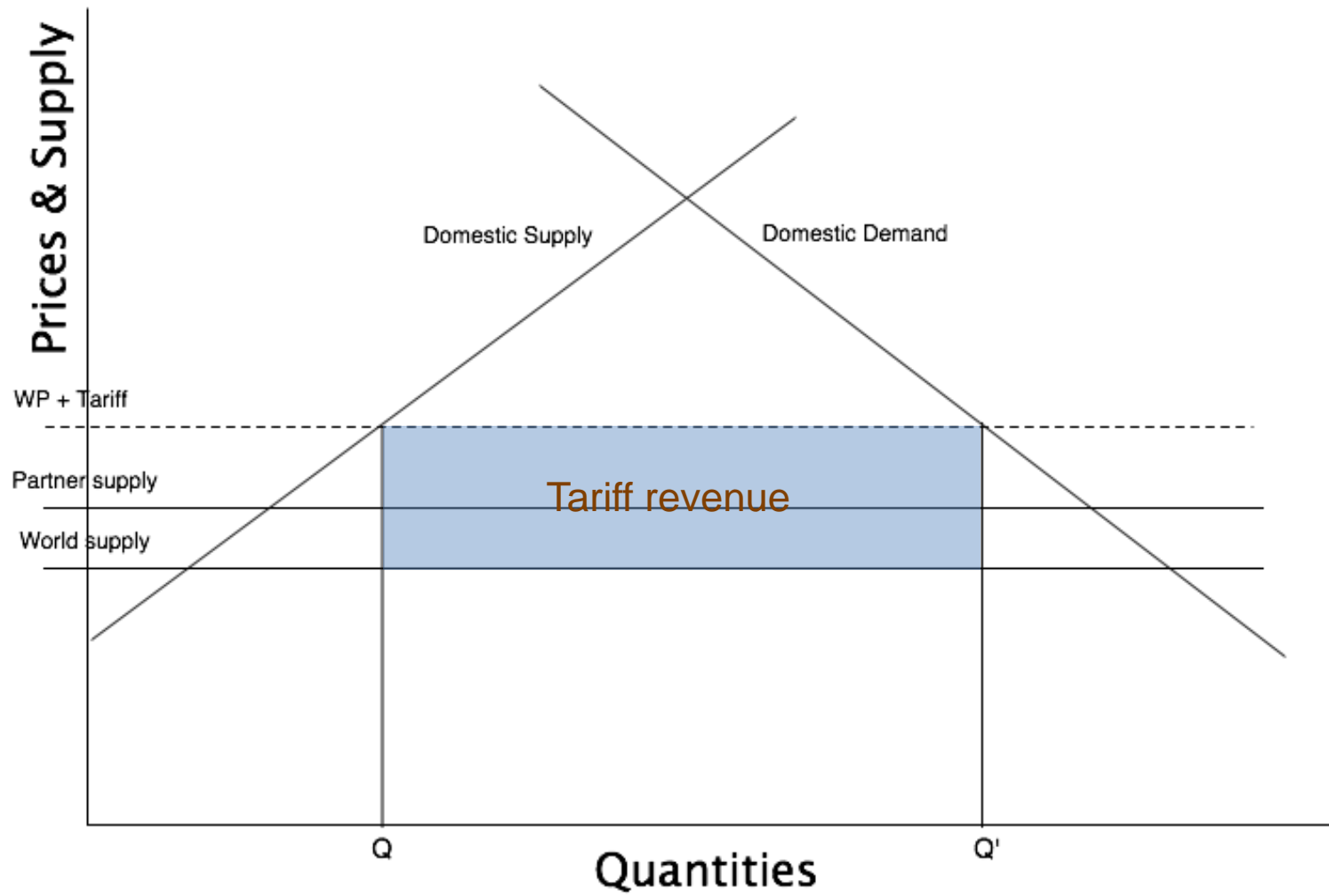


- Exports from FTA-partner countries will replace inefficient domestic production
 - It is called “trade creation”
- Exports from FTA-partner countries will displace exports from efficient non-partner countries
 - It is called “trade diversion”
- The keys issues for policy discussions are about
 - What would happen to efficiency?
 - What would happen to tariff revenue?
 - Is there any better option than joining an FTA?

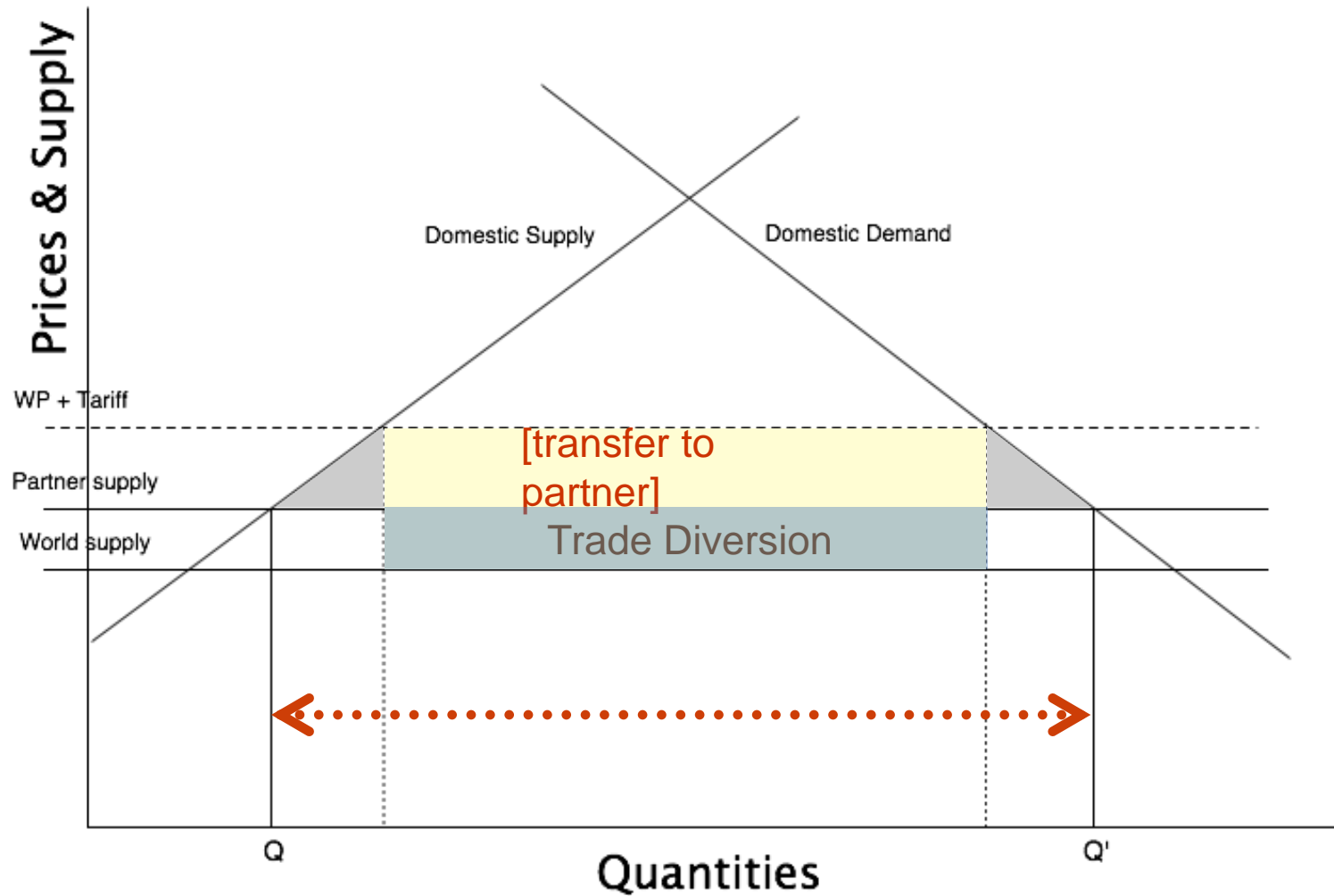


Illustration

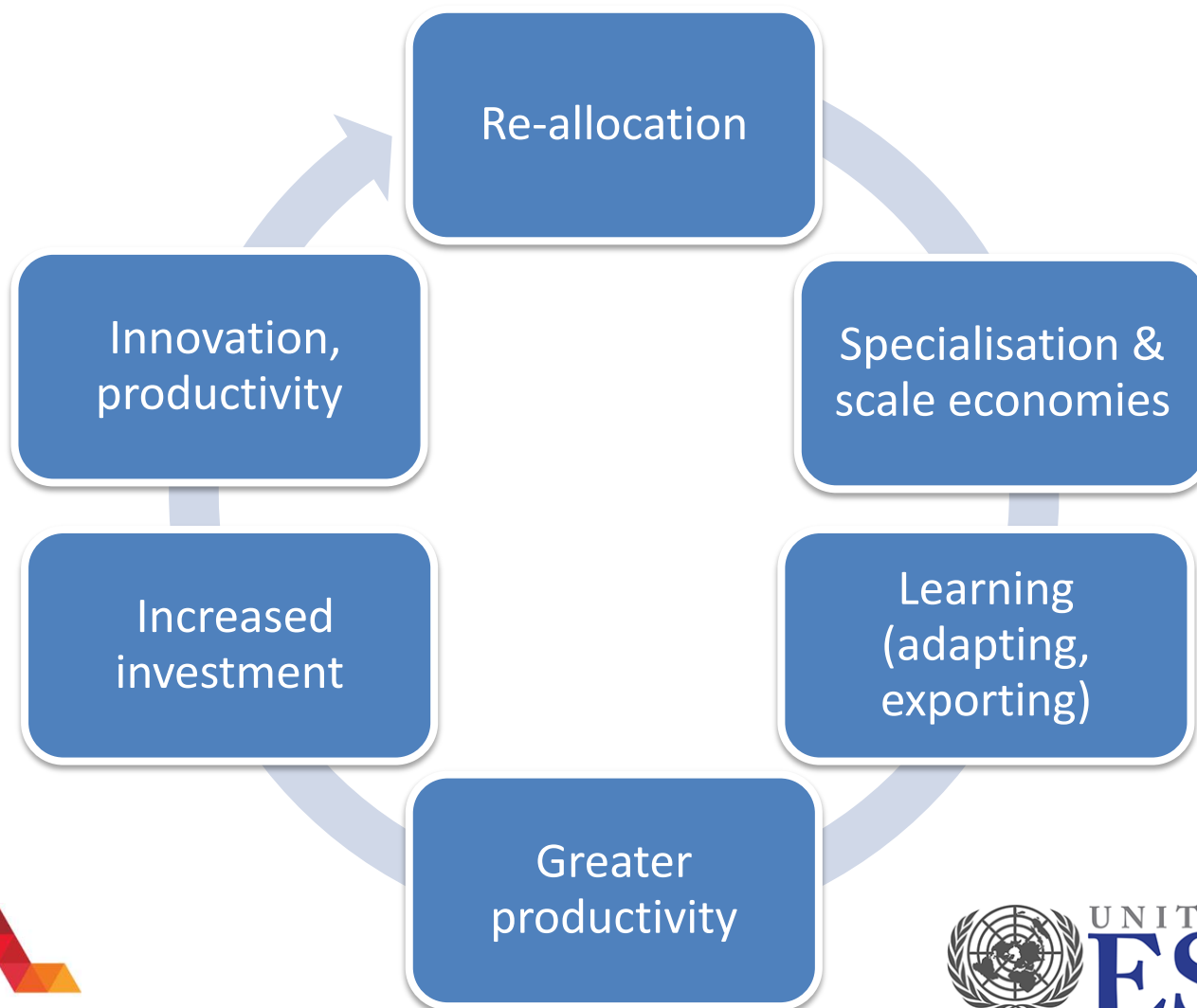




Summary: *the net trade effect depends on whether the loss of efficiency due to diversion (green rectangle) is greater or less than the gains in efficiency (grey triangles).*



Stylized dynamics



Effects when there are overlapping FTAs



There will be more than trade creation and trade diversion effects.

- **Trade creation:** Import from partner what was previously produced at home.
- **Trade diversion:** Import from partner what was previously imported from 3rd country.
- **Preference erosion:** Loss of a preference when a previous partner forms FTA with a 3rd country.
- **Trade reversion:** Import from new partner what had been diverted to a partner in prior FTA (Deardorff, 2014).
- **Noodle (or spaghetti) bowl effects:** problems of crisscrossing FTAs which arise from the application of **different rules of origin (Bhagwati, 1995).**

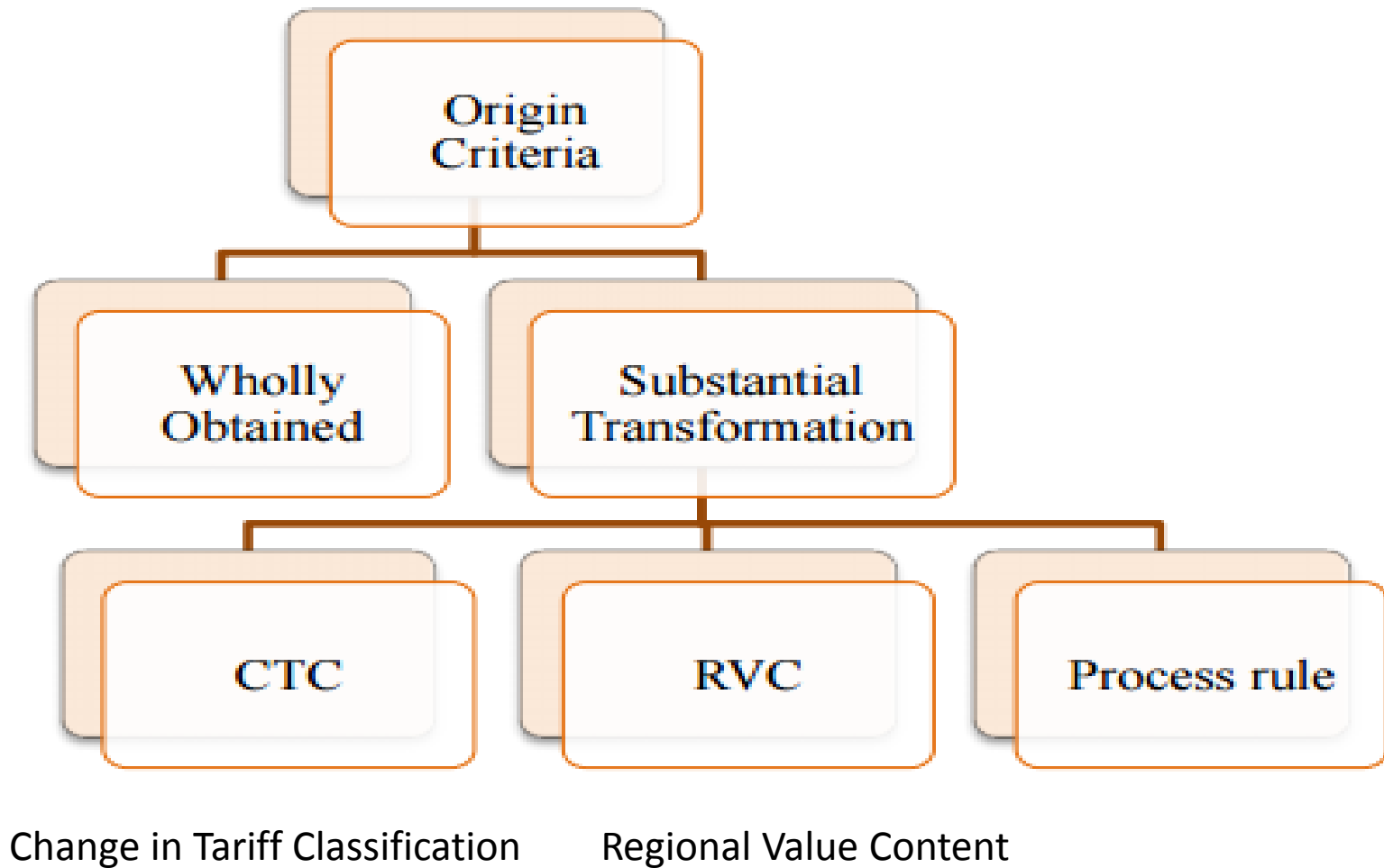




Rules of origin (RoO)



Different concepts for Rules of Origin



Why do we need the Rules of Origin in an FTA?



- FTAs extend preferential tariffs ONLY on products *originating* from the country/area.
- Rules of Origin (RoO) will determine which products are considered *originating*.
- Goods that satisfy the RoO under an FTA will be allowed to pay lower or no import tariffs when imported into a Party under the FTA.
- Unfortunately, RoO varying from FTAs to FTAs can be problematic to exporters.



Burden of the noodle bowls



- Overlapping and uncoordinated rules
- The complex rules and variable tariffs increase transaction costs
- Deter the use of FTA preference , particularly by small- and medium-sized enterprises (SMEs)
- One way to solve the problem is having an over-arching set of free-trade principles





Factors affecting utilization of FTAs



Evidence generally shows that FTAs are underutilized



- Examples of utilization rates of ASEAN countries

Country	FTA	AFTA
Indonesia	42%	51%
Malaysia	16%	39%
Singapore	21%	43%
Viet Nam	37%	65%
Average	26%	50%

Source: "FTAs in South-east Asia: Towards the next generation." Economist Intelligence Unit, 2014.



Factors for the success of PTAs



- Natural trading partners
- High margin of preference
 - High MFN rates
 - No other programme providing alternative incentives (EPZ, ITA, etc.)
- No replacement of protection (NTBs)
- Low cost of utilization (learning about FTA provisions, tailoring business plans to comply with the RoO and to obtain the C/O, Cost of compliance (with the rules of origin, etc.)
- Information availability (especially to SMEs)





Impact assessment of FTAs: an overview



Why is impact assessment so important?



- Joining an FTA is a costly way of trade liberalization
- Facilitate better trade negotiations
- Objective (unbiased) and transparent policymaking
 - Less susceptible to lobbying
- Identify ‘winners’ and ‘losers’
 - Targeted trade-adjustment assistance program
- Compare ex-ante predictions with ex-post actual impacts
 - Feed into future trade policymaking





Menu of choices

Purpose	Methods
Ex-ante overview of potential impacts	Use trade and trade-policy indicators
Ex-ante assessment of impacts on a specific sector/product	Partial-equilibrium models (SMART, GSM, TRIST)
Ex-ante economy-wide impacts	Computable general-equilibrium (CGE) models
Ex-post overview	Preference utilization indicators
Ex-post assessment of impacts	Gravity (econometric) models
Ex-post impacts on households and firms	Use survey data to run econometric models

Keep in mind that..



- Results are conditional upon the assumptions.
 - Some of the assumptions employed by the models, such as perfect competition and full employment, may not be realistic.
- The data limitations affect the feasibility of using different evaluation methods. For example,
 - sophisticated econometric models demand a lot of data, while simple trade indicators do not.
 - Even if sufficient data exists to make a method feasible, poor data quality may make the results of a study unreliable.
- FTAs may be designed to serve these unquantifiable economic or strategic purposes, such as structural reform and foreign relation.





Thank you

