The Rise Of Regionalism In The Multilateral System And Features Of Preferential Trade Agreements In Asia And The Pacific

Enhancing the contribution of PTAs to inclusive and equitable trade:

Viet Nam

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Workshop outline

- Trade, growth and development
- Trade protection and liberalization: from efficiency to meeting social objectives
- PTAs and multilateral trading system and PTAs in Asia-Pacific
- Trade reforms and PTAs of Viet Nam
- Towards PTA's contribution to inclusive and equitable trade
  - Viet Nam experience so far
- Getting a PTA done:
  - Stakeholders
  - Negotiation
  - Implementation
- What if the expectations are not met?

THE RISE OF REGIONALISM IN THE MULTILATERAL SYSTEM AND FEATURES OF PREFERENTIAL TRADE AGREEMENTS IN ASIA AND THE PACIFIC

SESSION 3

Key Learning Objectives

1. Understand the mechanisms of trade creation and trade diversion as they apply to PTAs and their welfare effects.
2. Identify the capacity for PTAs to act as "building blocks" or "stumbling blocks" with respect to multilateral liberalization.
3. Understand the key issues that arise in making PTAs more compatible with the multilateral system, and the way in which the multilateral system incorporates PTAs.
4. Recall three simple "rules of thumb" that help ensure PTAs are welfare-enhancing – these we will carry forward to other sessions.
5. Be informed of the main trends and developments in the PTAs of the Asia-Pacific countries.

Outline

1. Multilateral Trading System and Preferential Liberalization.

2. Economic Analysis of PTAs.

3. "Rules of Thumb" for Welfare-Enhancing PTAs.

4. Trends and features of PTAs in the Asia-Pacific region.

1. Multilateral Trading System and Preferential Liberalization

The session will be guided by:

- Multilateral liberalization is always welfare enhancing for small countries, and is desirable for large countries once political economy effects and reciprocity are taken into account.

- As we know from the literature, preferential liberalization through an agreement with one partner, or a small number of partners, is always ambiguous from an economic welfare point of view, for large and small countries alike.

- But for a variety of reasons, progress on multilateral liberalization has become difficult, while many countries are moving forward on PTAs.
  - South-South PTAs.
  - North-South PTAs.
  - "Mega-Regionals".

- Are there ways in which countries can "multilateralize regionalism"?

- How can the multilateral trading system (MTS) deal with the growth of PTAs?

1. Multilateral Trading System - Principles

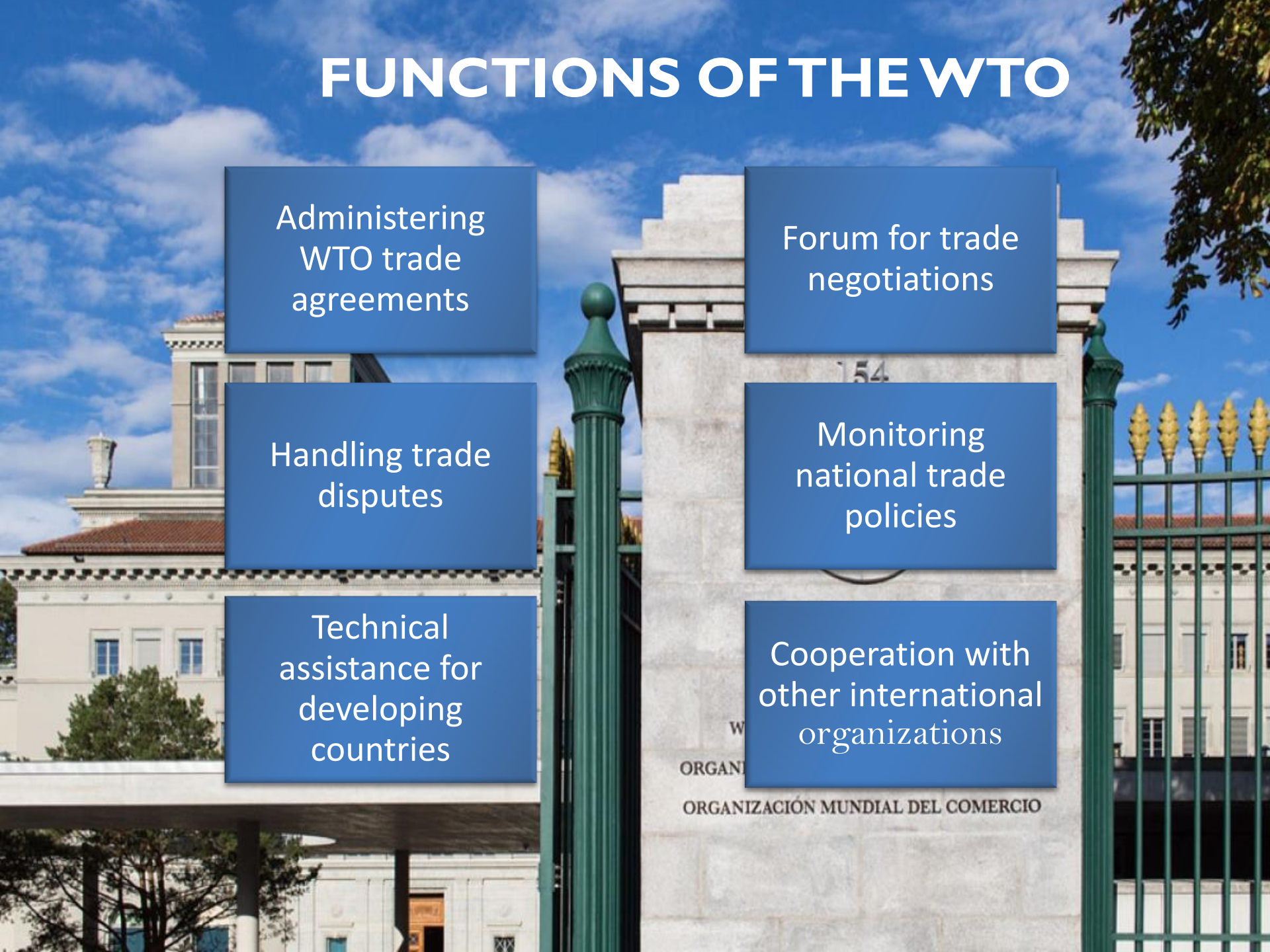
The multilateral trading system (MTS) should be…

- Without discrimination
  - Between countries ("Most Favoured Nation")
  - Between foreign and domestic products ("national treatment")
- Freer – Barriers coming down through negotiation
- Predictable
- More competitive
- More beneficial for less developed countries

It was "overseen" by GATT (1947-1994) and then WTO (1995-present)

FUNCTIONS OF THE WTO

- Administering WTO trade agreements
- Forum for trade negotiations
- Handling trade disputes
- Monitoring national trade policies
- Technical assistance for developing countries
- Cooperation with other international organizations



1. Multilateral Trading System and Preferential Liberalization - evolution

1. 1958-1988
   - N-N regionalism & Quad multilateralism works (70% of world trade) & N unilateralism begins.
   - S-S regionalism fails & South multilateralism fails.
2. 1990 – today
   - N-S regionalism takes-off (EU & US with nearby partners).
   - Some S-S regionalism works (Mercosur, SACU).
   - South unilateralism takes-off.
   - Proliferation of minor S-S trade agreements.
   - Multilateralism expands (Single Undertaking).
3. 2000 – today
   - East Asian regionalism takes-off (N-S & S-S RTAs).
   - Proliferation of minor trade agreements but also appearance of mega-regionals.

1. Multilateral Trading System and Preferential Liberalization

- When looking at the relationship between regionalism and multilateralism, there are two (opposing) arguments
- The building block (stepping stone) argument
  - Some liberalization is better than none!
  - As more and more countries enter trade agreements and reduce internal tariffs, it becomes easier to negotiate multilateral tariff reductions
  - When major countries conclude trade agreements, others can be spurred to complete multilateral deals so as not to be excluded
    - Think "NAFTA in the Uruguay Round"

1. Multilateral Trading System and Preferential Liberalization

- The stumbling block argument
  - Countries can become "content" with preferential liberalization, reducing the incentive to engage in multilateral liberalization
  - Preferential agreements can be "paper tigers", and not really prepare the groundwork for additional liberalization
  - North-South preferences create a constituency against multilateral tariff reductions so as to preserve preference margins
    - Think "Everything But Arms and EPAs in the Doha Round"

1. Multilateral Trading System and Preferential Liberalization (summing up the arguments)

"Building Block" Thesis

- Quicker and deeper integration: same goal, different routes through open regionalism
- Large PTAs increase the incentive for the outsiders to advance multilateral liberalization to minimize trade diversion
- Improved negotiating power for small units
- Laboratories for testing new approaches (services, investment, competition policies)
- PTAs as a development tool: incubator of production and export diversification and strategic integration into world economy

"Stumbling Block" Thesis

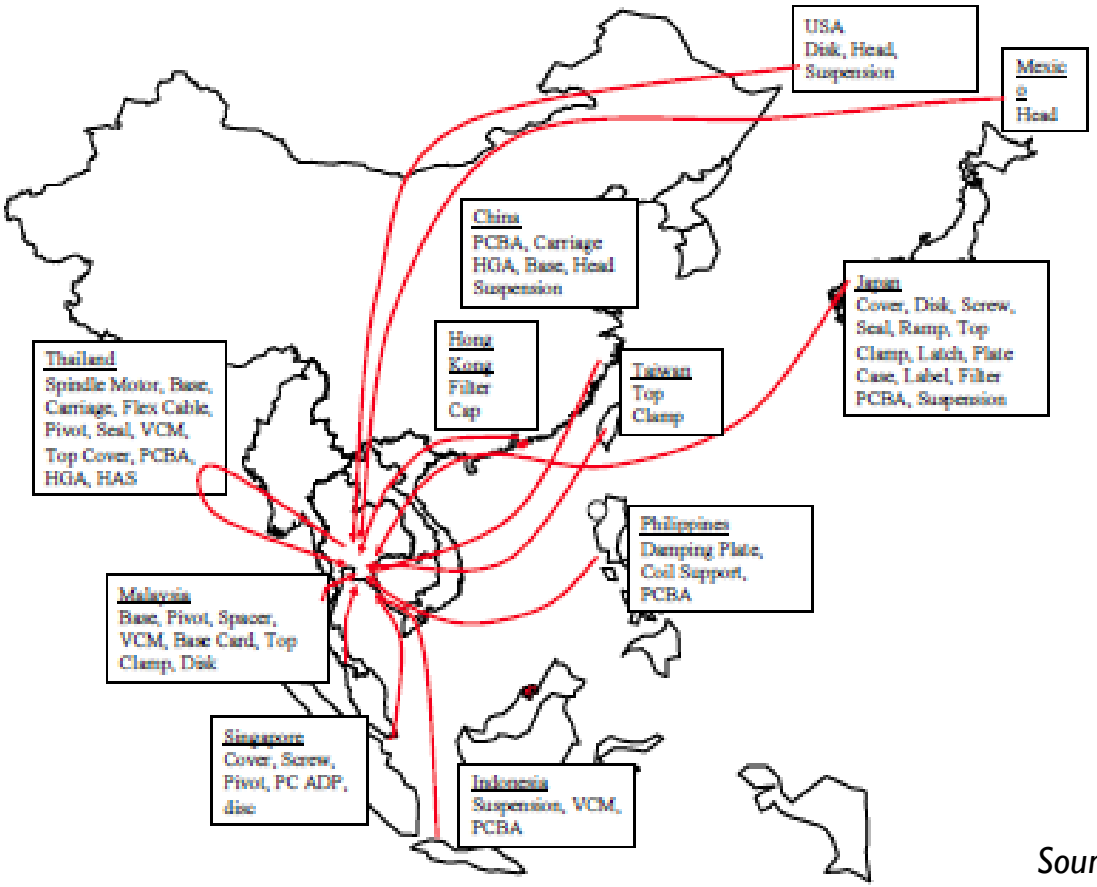
- PTAs create incentive to resist multilateral liberalization, which would erode preferences by reducing external MFN tariffs
- Market access preferences are used as bargaining chips by preference-granting nations against nontrade concessions
- Specialization of areas , "forum shopping"
- Administrative burdens and negotiating capacity constraints
- Fragmentation of regional rules in new areas and jurisprudence

1. Multilateral Trading System and Preferential Liberalization

- What does the empirical evidence say:
  - Stumbling block
    - USA
    - EU
  - Building block
    - Latin America
    - ASEAN
  - Neither
    - 23 large trading nations

1. Multilateral Trading System and Preferential Liberalization

Patterns of global sourcing (e.g., for this hard drive) might act as an incentive to multilateralize regionalism, or at least simplify it



Source: Baldwin 2006

1. Multilateral Trading System and Preferential Liberalization

- How to design preferential trade agreements (PTAs) that support, not undermine, the MTS?
  - Maximize trade creation, minimize trade diversion
  - "Open regionalism"—allow accession by countries willing to accept the rules
  - Make increased use of third-party MFN clauses in PTAs
    - Whatever preference is given to a third-party in the future is automatically extended to the original PTA parties

1. Multilateral Trading System and Preferential Liberalization

- How to design PTAs that support, not undermine, the MTS?
  - Simplify, liberalize, and harmonize as far as possible Rules of Origin (ROO)
  - Simplify and harmonize PTAs by "macro-region"
    - e.g., APEC codes of conduct on trade in goods, TBT, transparency, government procurement, dispute settlement, etc.
  - Pursue deeper integration in a way that is as non-discriminatory as possible, e.g. general regulatory reform

1. Multilateral Trading System and Preferential Liberalization

- How do the WTO Agreements treat preferential integration?
  - GATT article XXIV legalizes specifically regional trade agreements as:
    - Free Trade Areas (FTAs) or customs unions (FTA + common external tariff)
    - Purpose should be to facilitate intra-bloc trade, not raise barriers against extra-bloc trade
    - Duties cannot be higher than they were prior to the FTA
    - Elimination of duties, etc., affecting substantially all trade
    - Soft obligation to implement over a reasonable time period
  - Similar provisions in the GATS, and some other agreements (see next slide)

Three sets of rules on PTAs for WTO members

	GATT Art. XXIV	Enabling Clause	GATS Art. V

Features	• Main provision of GATT, 1994 "Understanding"
	• Dictates minimal requirements for PTAs (goods)
	• Elimination of "*duties and other regulations of commerce*" on "*substantially all*" trade
	• Within a "*reasonable*" period of time (Understanding ~10 years)
	• No increase in duties for non-members
		• Tokyo Round (1979) rules on preferential trading between developing countries
		• Under its terms, less scrutiny than Art. XXIV. Developing countries can
		  • agree to reduce but not eliminate tariffs and other trade barriers
		  • and/or be more selective in sectoral coverage
			• Dictates minimal requirements for PTAs (services)
			• Calls for "*substantial sectoral coverage*", and elimination of "*substantially all discrimination*" within a "*reasonable*" time frame
			• No increase in level of protection for non-members
			• Where developing countries are parties to an agreement there may be (unspecified) "flexibility"

Coverage	• N-N, N-S PTAs in goods	• S-S PTAs in goods	• All PTAs in services
***WTO* Consist-ency**	• The Czech-Slovakian CU is the only modern PTA that has been formally sanctioned by WTO / GATT • In 2006 Members adopted a "transparency mechanism" based on early announcement and notification to the WTO of any new PTA. Also it provides for a comprehensive "factual presentation" after adoption followed by a single discussion among the Membership → in essence, *agnostic* on the questions of compliance		

1. Multilateral Trading System and Preferential Liberalization

- How *could* the WTO Agreements treat preferential integration?
  - Become more active—support the UMP approach
    - Unilateral reform is best
    - Multilateralism and reciprocity is second best
    - Preferential integration is third best
  - Promote multilateral preferential-ism, i.e. agreements that anyone *can* join, but not everyone *does* join
    - Information Technology Agreement
    - Government Procurement Agreement
  - Develop a serious review mechanism
  - Simplify and harmonize rules of origin
    - Eliminate sector-specific ROO
  - Require MFN tariff reductions—even small ones—as the "price" of entering a PTA

Summing up: How to best manage the growth of PTAs?

Possible Approaches to Multilateralization

1

- Open up Preferential Trade Agreements (PTAs) to easy accession by non-members

2

- Reduce the margin of preference by liberalizing MFN duties (e.g. in the Doha Round)

3

- "Harmonize" or homologate the rules of origin (ROO)

4

- Create new 'mega' regional groups (FTAAP) - this would overlay and supplant smaller PTAs

!

All PTAs have a discriminatory impact

- Transparency may improve the function of the 'market for PTAs': possibly keeping discrimination in check, since the partners must consider the potential demand of third parties for 'equivalent' access

2. Economic Analysis of PTAs

- There is a basic tension in a preferential trade liberalization:
- PTAs embody "discriminatory liberalization"
  - Liberalization tends to boost economic efficiency (good)
  - Discrimination tends to reduce economic efficiency (bad)
- How can we analyze these effects in more detail? (annex)
- Which effect dominates for particular agreements?

2. Economic Analysis of PTAs

- Let's take a simple example to see what's going on

- Initial setup
  - Peru imports clothing from China and Viet Nam
  - T-shirts from China cost $10 on the world market
  - T-shirts from Viet Nam cost $11 on the world market
  - Peru initially applies a tariff of 20% to clothing from both origins
  - Peruvian consumers tend to source from China ($12) rather than Viet Nam ($13.20)

2. Economic Analysis of PTAs

- Experiment 1: Peru and China conclude an PTA
  - Assume prices stay the same on the world market: Vietnamese t-shirts are $11, and Chinese ones are $10
  - In the Peruvian market, Chinese t-shirts now sell for $10, but Vietnamese t-shirts still sell for $13.20
  - Peruvian consumers keep sourcing from Chinese suppliers, but the lower price means that they buy more
  - The PTA results in *trade creation*

2. Economic Analysis of PTAs.

- Experiment 2: Peru and Viet Nam conclude an PTA
  - Assume prices stay the same on the world market: Vietnamese t-shirts are $11, and Chinese ones are $10
  - In the Peruvian market, Chinese t-shirts continue to sell for $12, but Vietnamese ones now sell for $11
  - Peruvian consumers now tend to source from Viet Nam rather than China
  - The PTA results in *trade diversion*, since Peru's imports are now sourced from a higher cost supplier

2. Economic Analysis of PTAs

- To summarize, Home's preferential tariff to Partner
  1. Allows Partner to sell more, and at a better price
  2. Means that the Rest of the World sells less, and at a worse price
  3. Home expands imports, but has two terms of trade effects
     - Pay more for imports from Partner
     - Pay less for imports from the Rest of the World
  4. Home loses some tariff revenue as well (may boost other tax revenues through)

2. Economic Analysis of PTAs

- Traditional trade diversion and creation effects are not the only economic impacts of PTAs

- PTAs also give access to a larger home market, which enables producers to realize greater scale economies
  - Of course, multilateralism can give rise to an even bigger home market!

2. Economic Analysis of PTAs

- What is beneficial about having a larger home market?
  - Small markets mean that only a few firms can survive
  - Those firms need to charge high prices to be able to survive…
  - And the lack of competition makes it possible to do so
- A larger home market increases firm scale and supports stronger competitive discipline
- If each firm makes a slightly different product—which is what most models assume—then a larger market is also linked to greater export diversification

2. Economic Analysis of PTAs

- As markets integrate through regionalism, there is a pro-competitive effect that reduces margins…
- And squeezes the least productive firms out of the market…
- Which allows the strongest firms to grow
- The net result of the shake-out is a smaller number of bigger, more efficient firms facing enhanced competition
- The economy gains from lower prices and greater consumption (an engine of growth)

3. "Rules of Thumb" for Welfare-Enhancing PTAs

- Designing PTAs is becoming increasingly complex
  - Sectoral coverage
  - Issue coverage
  - Rules of origin and relationship to other PTAs
  - Relationship with the multilateral system
  - GVCs and global sourcing

- Is it possible to come up with a few general principles that will help ensure that PTAs are welfare-enhancing for developing countries?
  - Social and environmental issues are considered in the next sessions, which look in detail at coverage and modalities for inclusive PTAs.

3. "Rules of Thumb" for Welfare-Enhancing PTAs

1. Target preferential treatment at low-cost suppliers, preferably world leaders
   - Maximize trade creation
   - Limit trade diversion
   - Implications for South-South RTAs?

3. "Rules of Thumb" for Welfare-Enhancing PTAs

2. Keep preferential and MFN tariffs low
   - Limits the scope for trade diversion
   - Maximizes the probability of trade creation

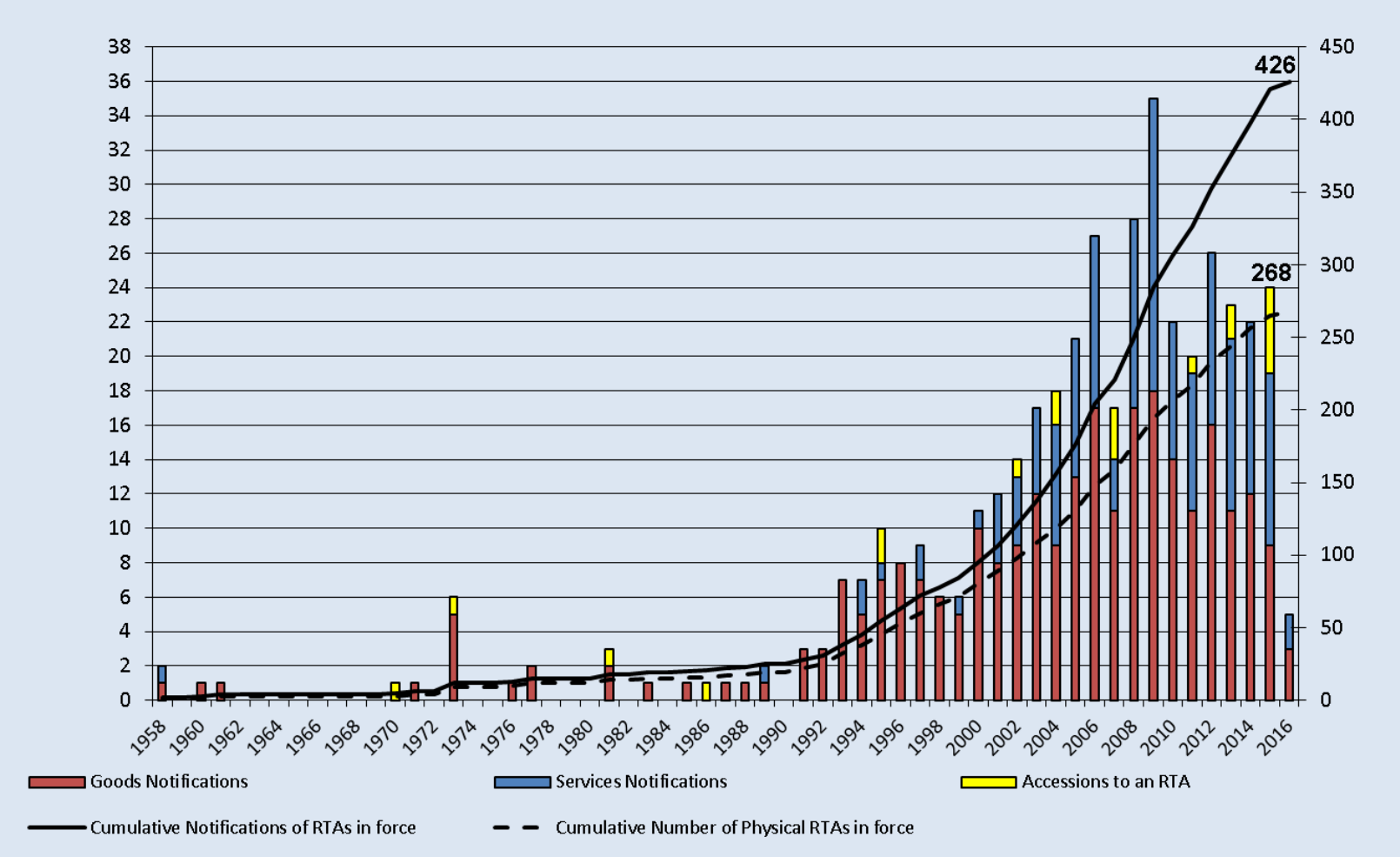
3. "Rules of Thumb" for Welfare-Enhancing PTAs.

3. Gains are larger from integrating with markets that are
   - Large relative to the home market
   - Have relatively high levels of protection prior to integration
   - Are sufficiently similar to make "deep" integration a realistic possibility

3. "Rules of Thumb" for Welfare-Enhancing PTAs

4. The risk of trade diversion is diminished, and preference utilization is increased, if liberal rules of origin are included.
   - ROOs should not unduly constrain firms in input choice—hinders global competitiveness, and limits preference uptake.
   - If integration is with an otherwise appropriate (competitive) partner, liberal ROOs provide a strong assurance that trade creation will dominate trade diversion, and the agreement will be welfare-enhancing.

4. PTA Trends & Characteristics: Global Picture

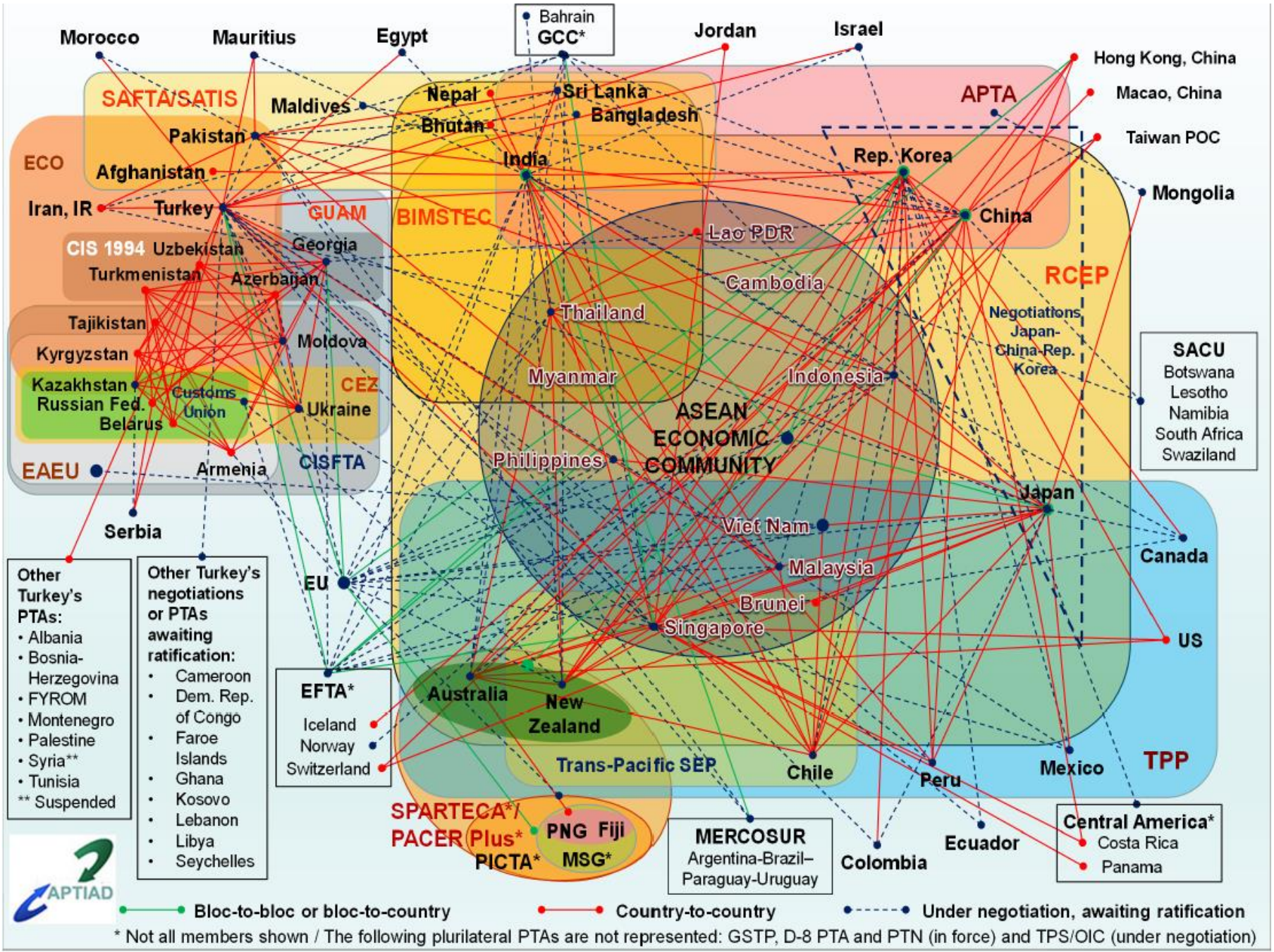


- As of October 2016, 268 PTAs have been notified to the GATT/WTO and are currently in force
- Approximately 80 PTAs in the pipeline (signed or under negotiation) – Unaccounted number of PTAs in force but not yet notified

4. PTA Trends & Characteristics: Asia-Pacific

1. Too many overlapping bilateral RTAs leading to "noodle bowl" but at the same time fragmentation of the region.
2. Weak capacity to utilize research in setting negotiation strategy/mandate, weak negotiation and implementing capacity.
3. Under-utilization of negotiated preferences.
4. "Next generation" PTAs may be imposing regulatory regimes that are too advanced.
5. Inclusivity/equality/fairness/sustainability concerns and post-adjustment are not addressed

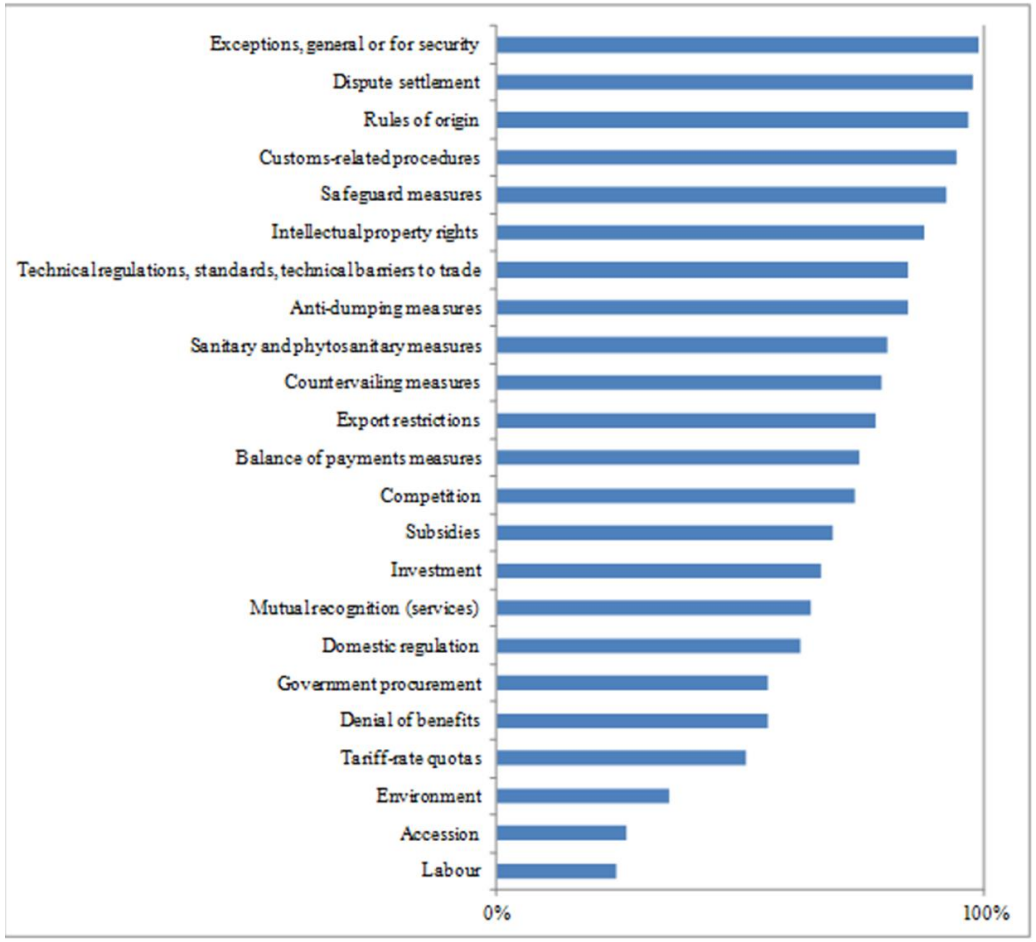
OVERLAPPING AGREEMENTS – NOODLE BOWL



4. Trends & Characteristics: Effects of Overlapping PTAs

- Four main effects (Deardorff, 2014)
- Trade creation: Import from partner what was previously produced at home
- Trade diversion: Import from partner what was previously imported from a 3rd country
- Preference erosion: Loss of a preference when a previous partner forms PTA with a 3rd country
- Trade reversion: Import from a new partner what had been diverted to a partner in prior PTA

4. Trends & Characteristics – Coverage of Asia-Pacific countries' PTAs



Source: WTO, Regional Trade Agreement Information System (RTA-IS) database, accessed 1 August 2016.

Conclusion

1. The welfare effects of entering into a PTA are ambiguous due to the potential for trade diversion as well as trade creation.
2. When progress at the multilateral level is challenging, PTAs can seem attractive. Some can be building blocks, others can be stumbling blocks.
3. In designing and implementing PTAs, it is important to make them as compatible as possible with the multilateral system.
4. GVCs and complex global sourcing are additional reasons for simplifying and harmonizing PTAs, as well as "multilateralizing" them.
5. Asia-Pacific approach to PTAs – noodle bowl and associated effects

Annex

- Technical demonstration of trade creation and trade diversion (Economic analysis of PTAs)

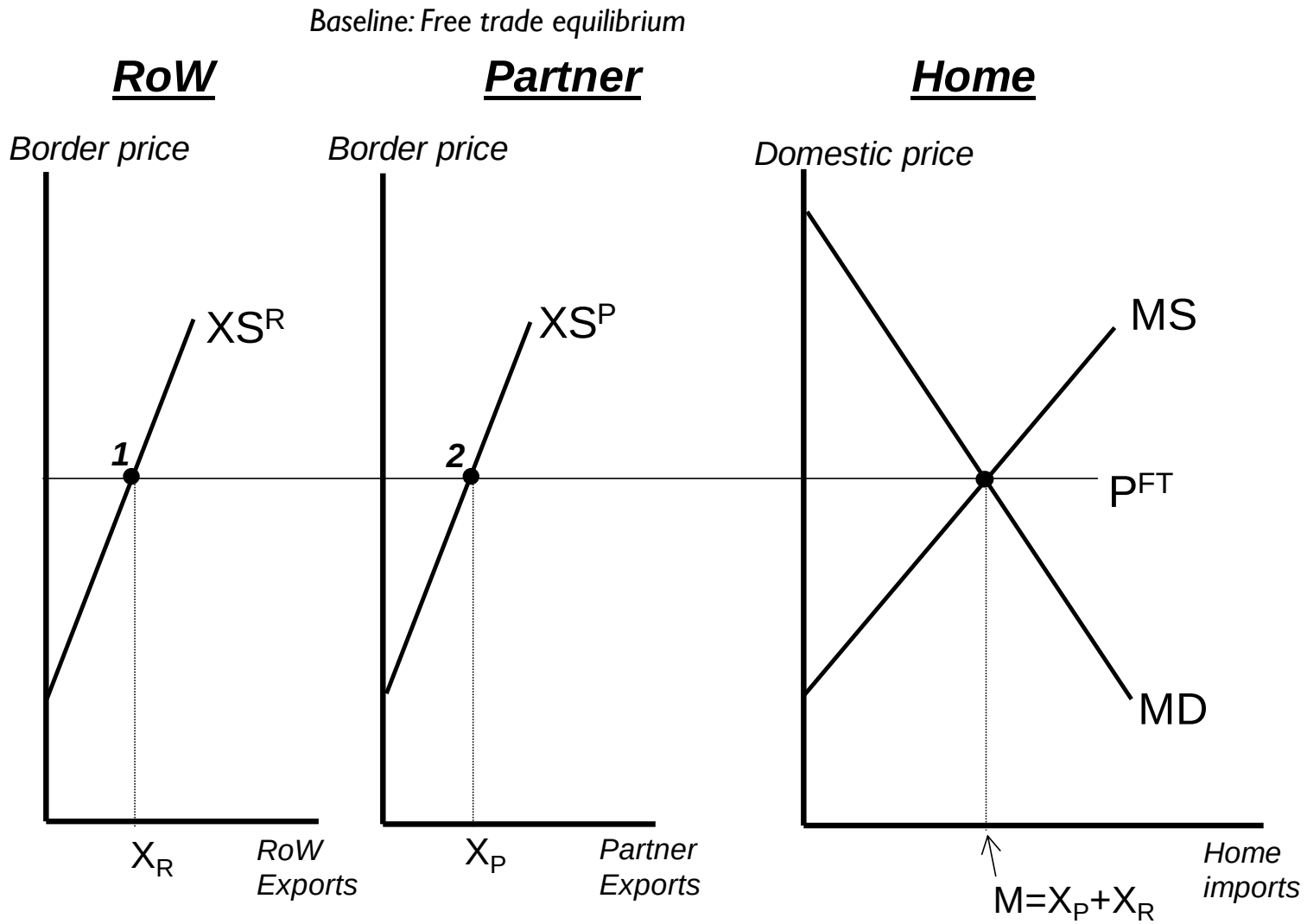
Economic Analysis of PTAs.

- In economic terms, the tension of PTAs is summarized by the two concepts of trade creation and trade diversion.

- The example considered a single market. In reality, a PTA covers many sectors—and can go beyond goods—so analyzing net effects is very complex.

- At the end of the session, we will develop some rules of thumb for helping ensure that trade creation dominates, which makes the PTA welfare-enhancing.

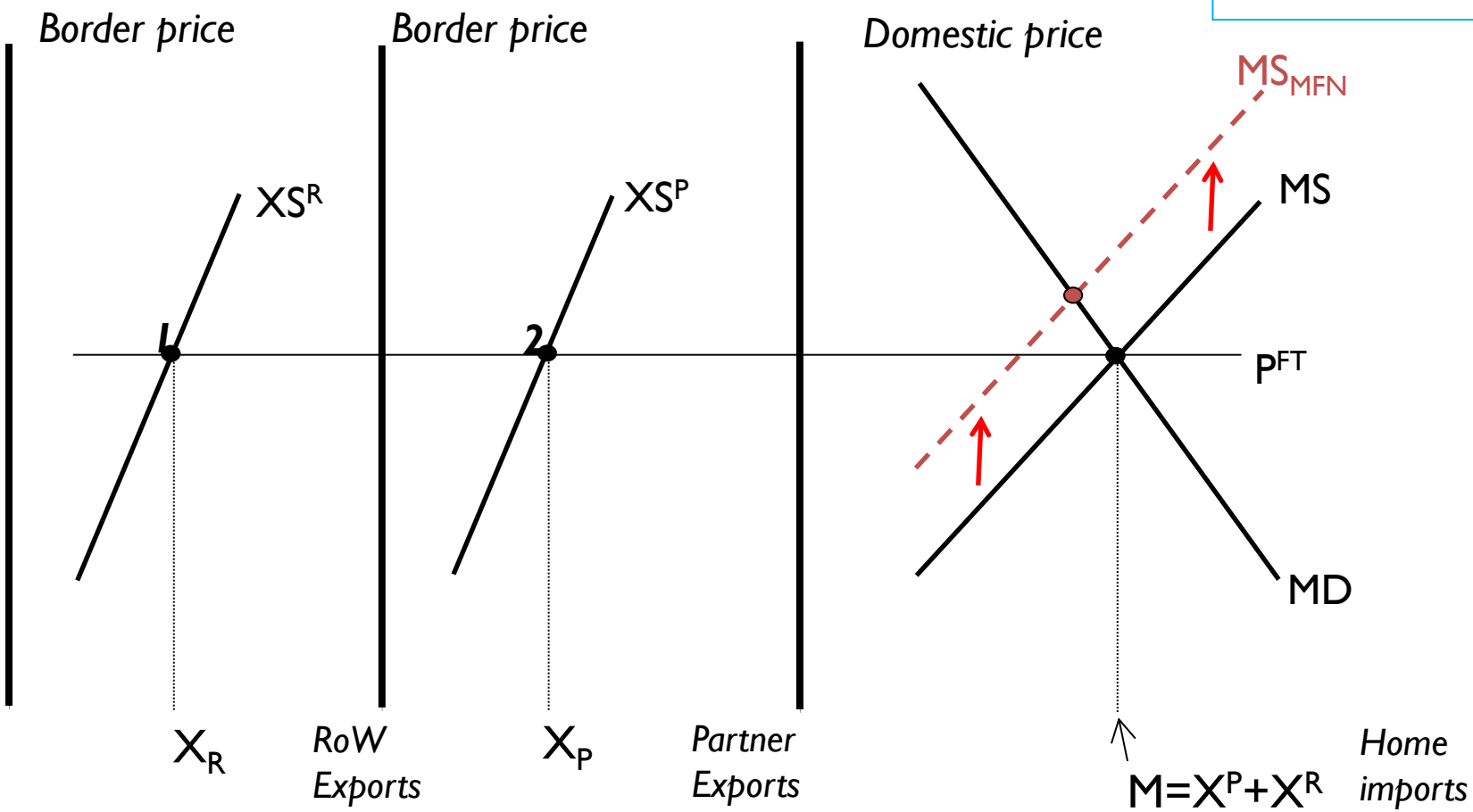
Economic Analysis of PTAs.



Economic Analysis of PTAs.

Part 2: MFN tariff

Step 1: Work out new MS.



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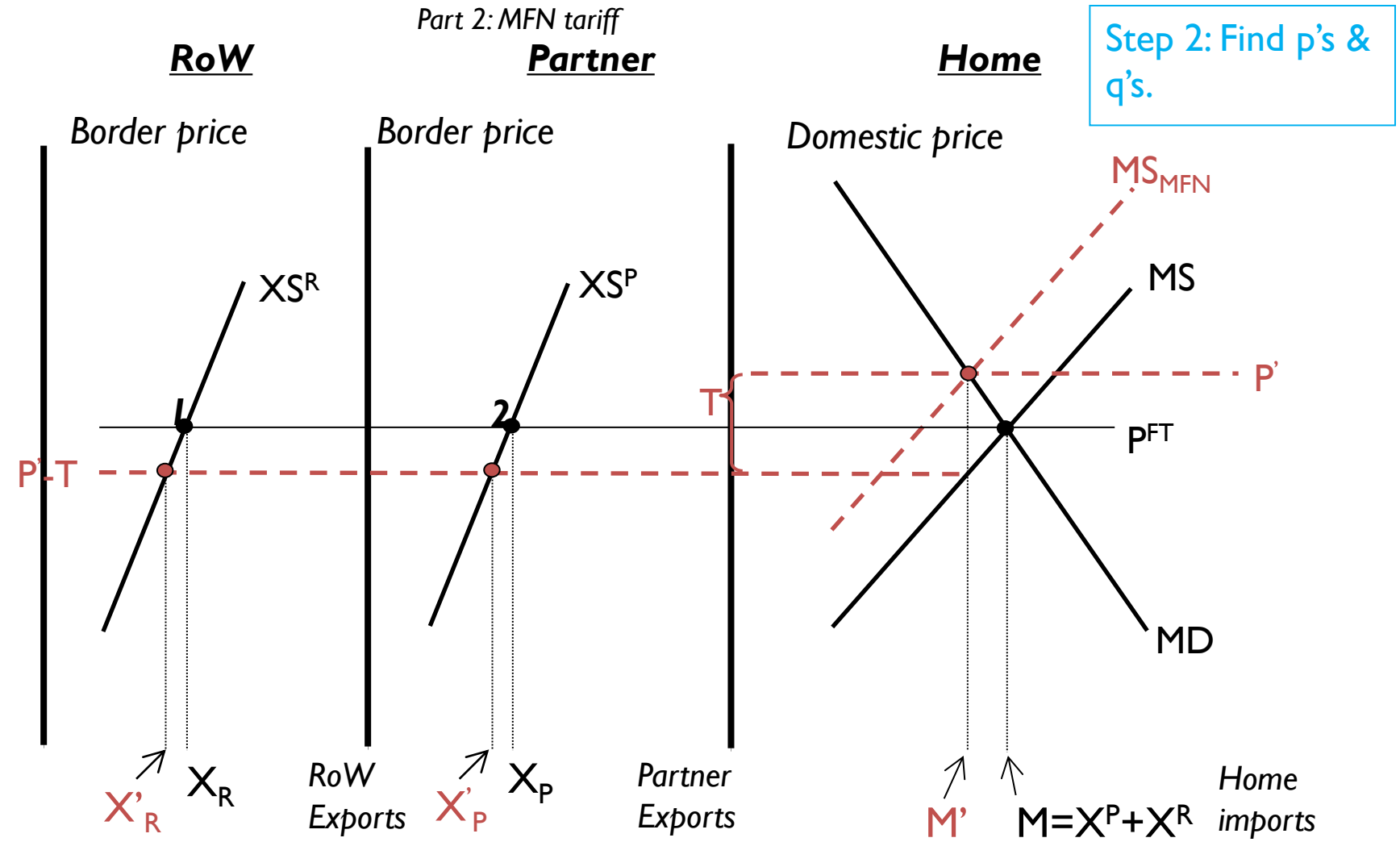
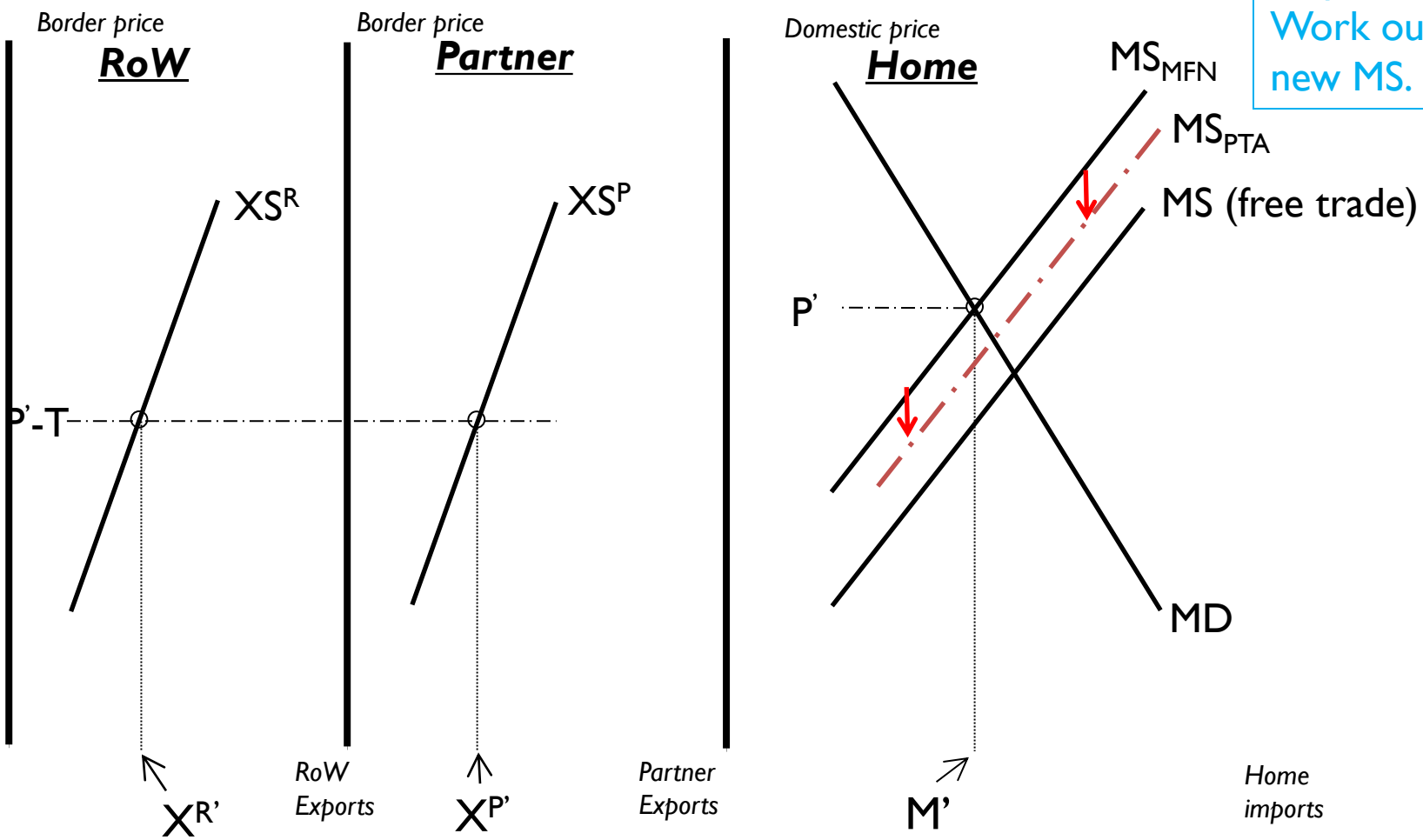


Economic Analysis of PTAs.

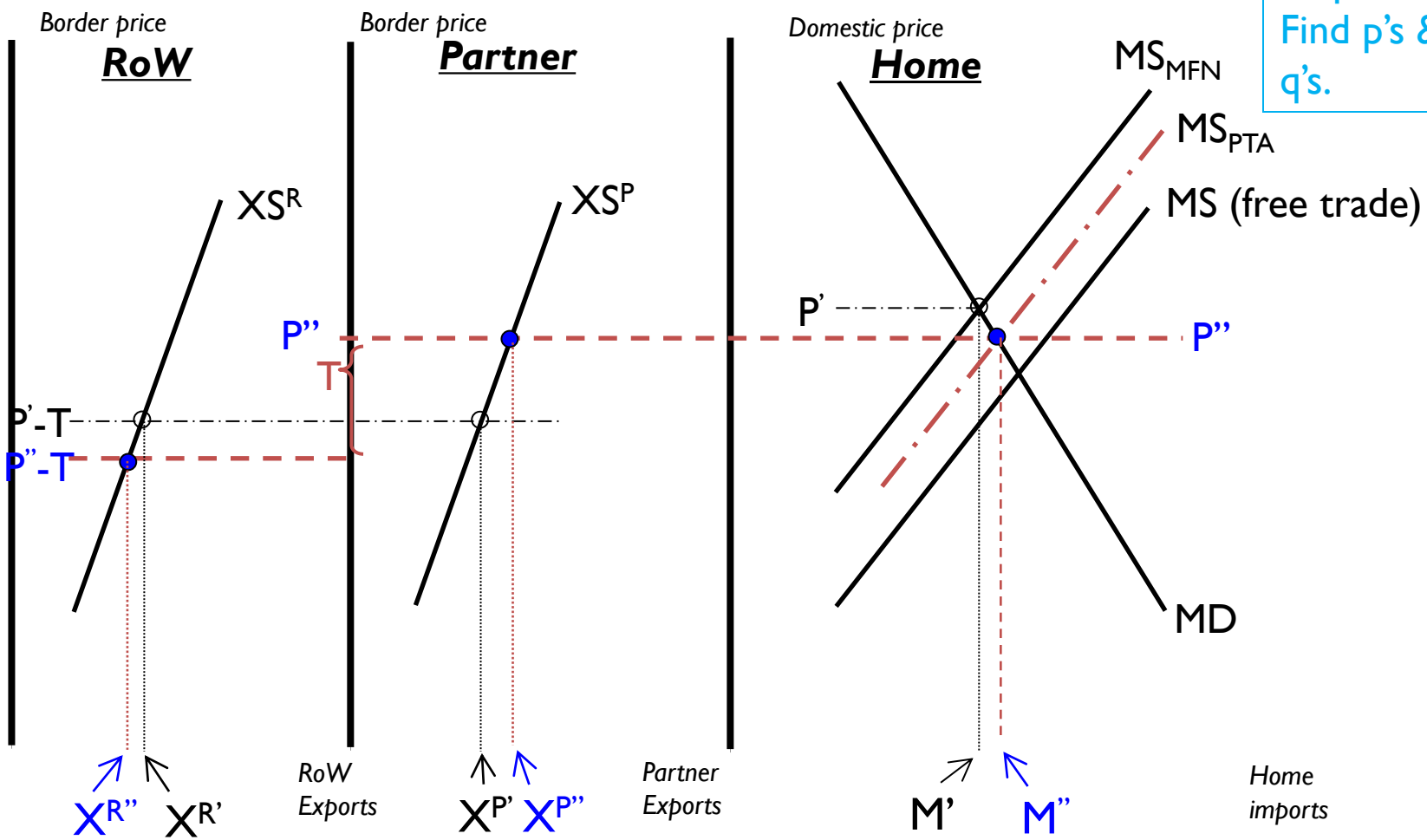
Part 3: Preferential liberalization

Step 1: Work out new MS.

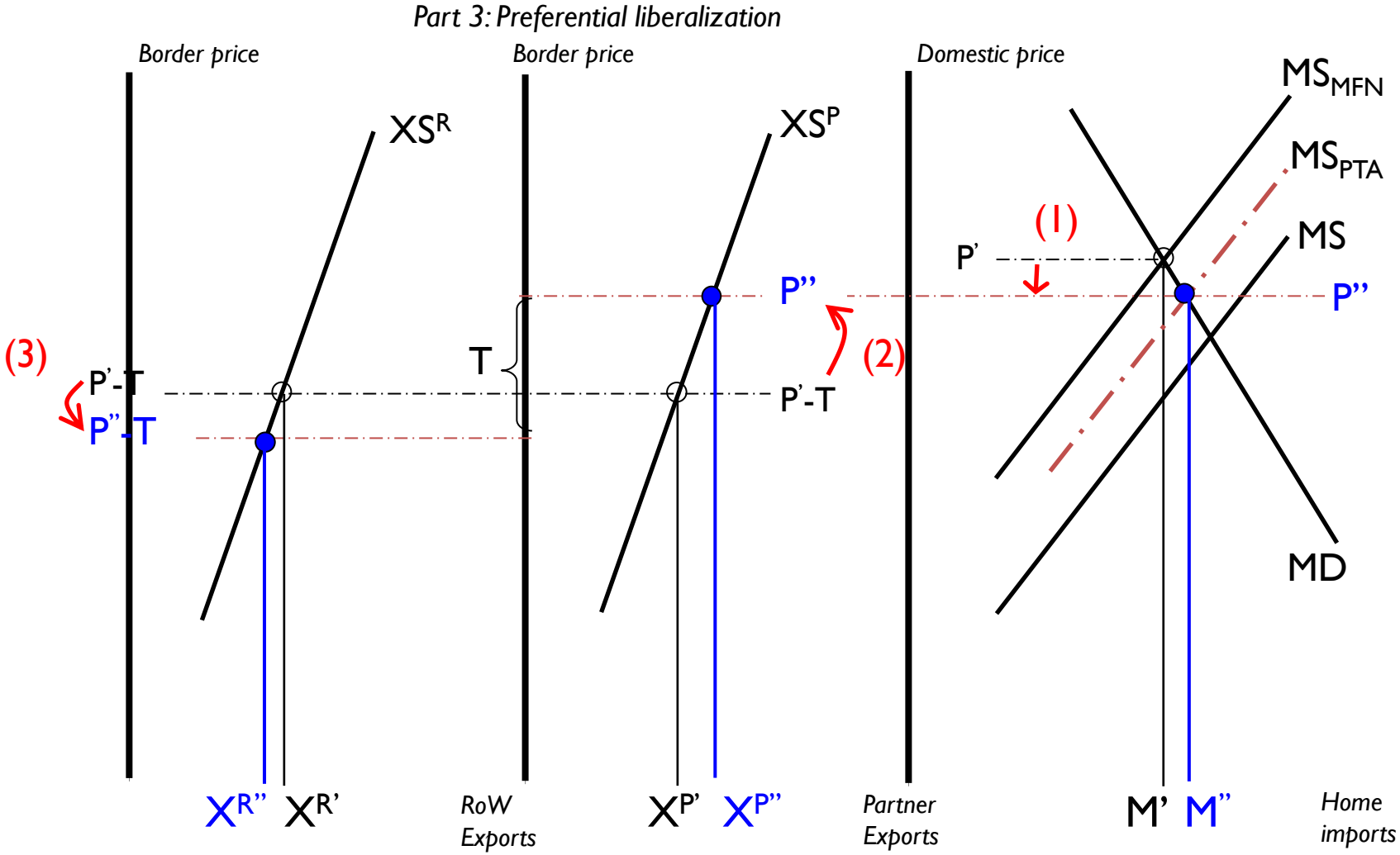


Economic Analysis of PTAs.

Step 2: Find p's & q's.

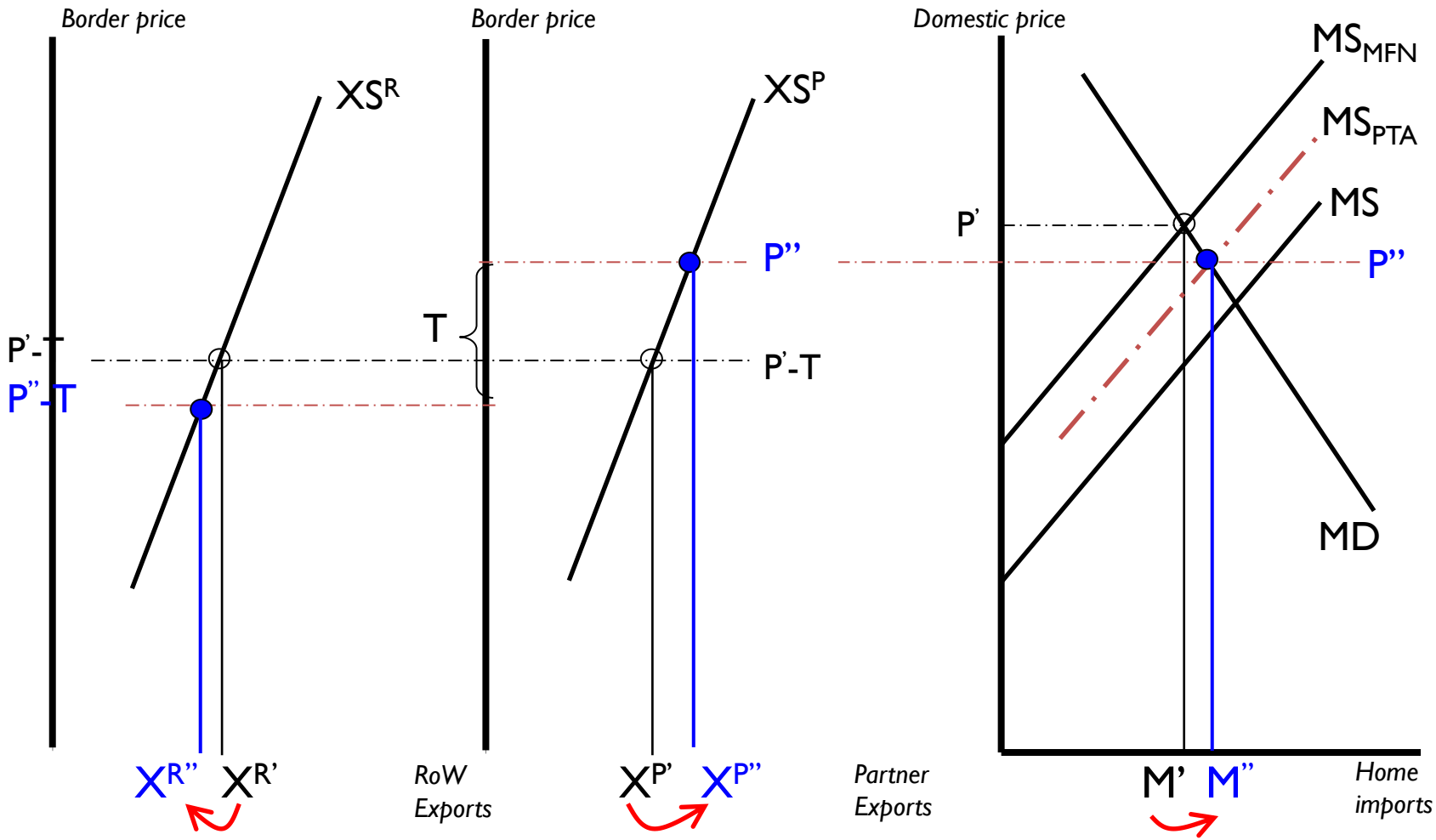


Economic Analysis of PTAs.



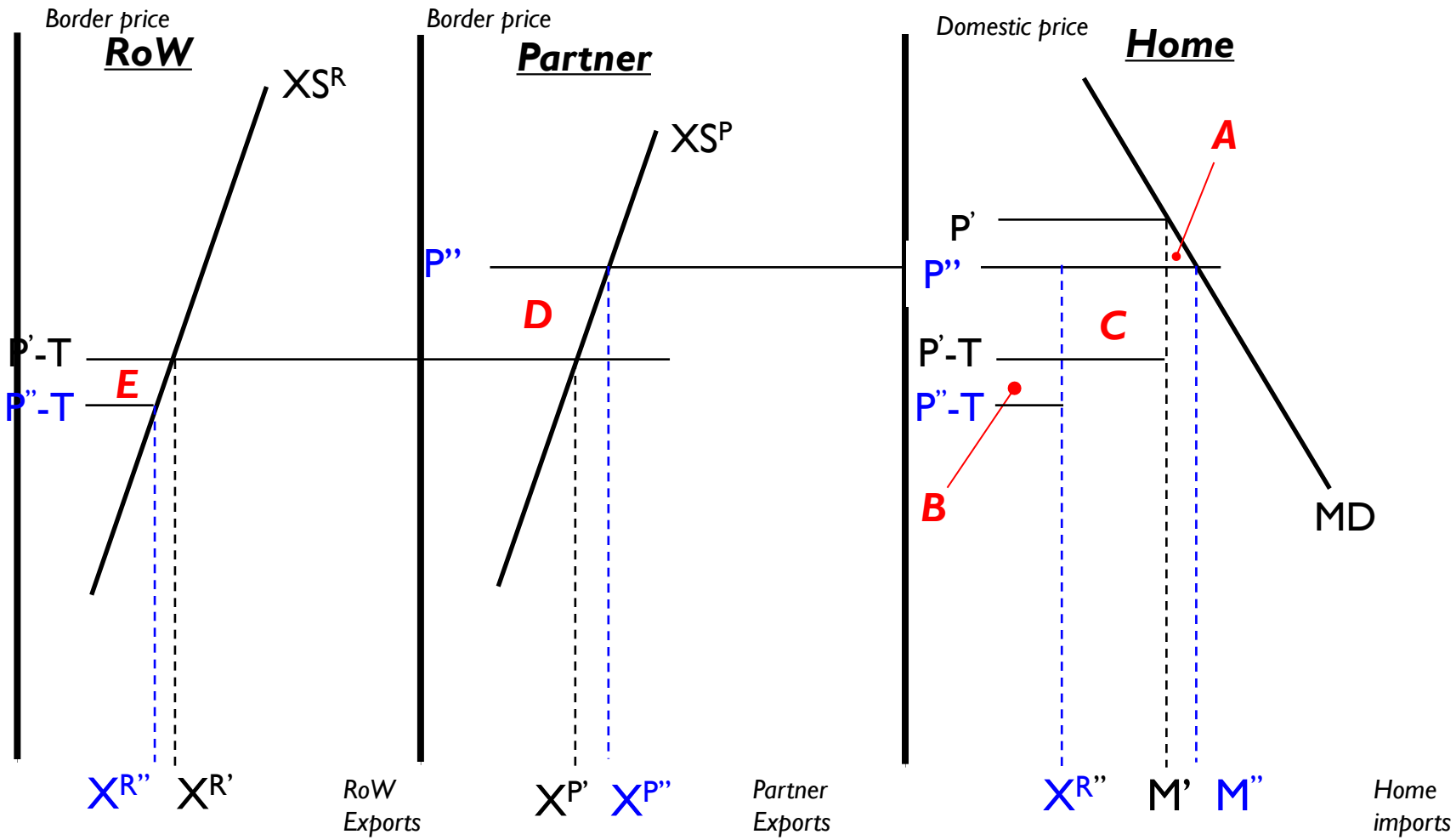
Economic Analysis of PTAs.

Part 3: Preferential liberalization



Economic Analysis of PTAs.

Part 3: Preferential liberalization—welfare effects



Economic Analysis of PTAs.

- To summarize, Home's preferential tariff to Partner
  1. Allows Partner to sell more, and at a better price (D)
  2. Means that the Rest of the World sells less, and at a worse price (E)
  3. Home expands imports (A), but has two terms of trade effects
     - Pay more for imports from Partner (A)
     - Pay less for imports from the Rest of the World (B)
  4. Home loses some tariff revenue (C)