



INSTITUTE FOR INTERNATIONAL BUSINESS, ECONOMICS & LAW

## Preferential Trade Agreements and the Role and Goals of the World Trade Organization

### Speaking Notes

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#### Introduction

In his introductory comment to a recently published volume of papers on Free Trade Agreements, former WTO Director-General Renato Ruggiero observes:

“There is a paradox in international trade policy today. Globalization is the word on everyone’s lips, yet regional agreements have never been so popular.”

Not surprisingly, Ruggiero goes on in his comment to urge continued support for the multilateral system of the WTO and warn of the negative consequences of regionalism – particularly where regional trade deals continue to be ineffectively supervised by the WTO.

Former Director-General Ruggiero’s comments are a good place to start my presentation because I think he has succinctly summed up what is a common theme these days. Ten years ago, at the conclusion of the Uruguay Round negotiations, multilateralism appeared triumphant as the WTO moved decisively away from the old GATT’s image as a Rich Man’s Club toward universal membership. Ten years later, only three of WTO’s 147 member governments are not part of any regional or preferential trade agreement and only one of these – at last count – was not involved in a negotiation aimed at creating an FTA.

In the paper that I have prepared for this conference, I briefly discuss the recent history of Preferential Trade Agreements (or PTAs) the term I use to refer to a variety of reasonably similar agreements. I then offer some possible explanations for the apparent proliferation of PTAs. Finally, I discuss the very important issue of ensuring the compatibility of PTAs with the WTO system.

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## Recent History of PTAs

The WTO's Doha Round of multilateral trade negotiations is not in great shape these days. The next two to three weeks will determine whether anything meaningful can be done in the Round this year. Many observers of the global scene remain hopeful, but many others are already to write off the Round.

Meanwhile we are witnessing an unprecedented degree of activity related to the negotiation and implementation of PTAs<sup>2</sup>. In the time since the launch of the Doha Round, Australia – long seen as one of the most ardent backers of the GATT-WTO – has negotiated and agreed PTAs with Singapore, Thailand and the United States and has accelerated a feasibility study of a PTA with China. Australia has also been invited by ASEAN members to consider joining New Zealand in a PTA with the regional grouping.

Australia's pace of PTA activity, while impressive, pales in comparison with that of the United States. As of today, Washington is simultaneously negotiating PTA's with the Andean Group, SACU, Bahrain and Thailand and there are signs that a negotiation might be possible with Malaysia.

Pending before the Congress are recently negotiated PTAs with Australia, the Central American Common Market, the Dominican Republic and Morocco. And the United States has not given up in its now-stalled effort to negotiate a PTA encompassing nearly all of the countries of the Western Hemisphere.

Washington's evident enthusiasm for PTAs has reached the point where one Congressional wag was overheard commenting that Bob Zoellick's next target for an FTA was a small rock in the outer asteroid belt.

Japan and Mexico have concluded a PTA, as have Korea and Chile. Singapore and Panama are exploring a deal. The European Union is in active negotiations on a PTA with Mercosur. Little wonder why, in the face of this activity, a number of commentators have speculated that at least some of the blame for the WTO Round's current sorry state should be ascribed to the enthusiasm key WTO Members are showing for PTA negotiations.

It is probably not possible to demonstrate a direct relationship between attitudes toward the WTO system and progress (or lack thereof) in WTO trade liberalization on the one hand and the tendency to engage in preferential liberalization through PTAs on the other hand. What one can say with a fair degree of certainty, however, is that the number of PTAs has grown importantly in recent years and continues to grow at a rapid rate. In its World Trade Report 2003, the WTO Secretariat estimated that, in addition to the 176 PTAs notified and in force, 70 PTAs were in force but not notified to WTO and an equal number were under active negotiation.<sup>3</sup>

## Explanations for the Proliferation of PTAs

### Characteristics of the WTO System

There are a number of political and economic explanations that can be developed for the growth in the number of PTAs in recent years. Some of these explanations are more convincing than others.

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<sup>2</sup> The term "Preferential Trade Agreement" will be used to refer to customs unions, regional trade and economic integration arrangements and bilateral free trade agreements.

<sup>3</sup> World Trade Report 2003, page 46, World Trade Organization, Geneva, 2003.

I believe, and I outline this in my paper, that there are some characteristics of the WTO system itself that contribute to the apparent allure of PTAs.

Without any doubt, WTO's culture of decision-making by consensus can be problematic. Sovereignty is protected and the WTO "constitution" is not frivolously amended, but the trade-off is that more positively-oriented decisions, such as the initiation of trade liberalizing negotiations, are far more difficult. If it is prepared to block consensus, tiny St. Lucia has a power equivalent to the United States.

So decision-making to progress trade liberalization in the WTO requires arriving at a point where none of the WTO's Members will oppose the negotiation. This is where we encounter another problem endemic to today's WTO – the very nature of its membership. The old GATT was derided as a "rich men's club" but it was also a club of countries for which international trade was important. The WTO of today includes scores of Members that taken together cannot account for even one percent of global trade. If trade is not yet an important element in these countries' international relations, it is much harder for trade-minded countries to persuade or cajole them into cooperating with a forward-looking trade agenda. The problem is of course, aggravated by these WTO Members' low capacity to participate actively in either the negotiations or in subsequent implementation of negotiated results.

A very important point to bear in mind is that the WTO is not currently capable of judging the compatibility of PTAs with rules governing the legality of these arrangements. The system -- which is supposed to operate through review and analysis of notified PTA's in the Committee on Regional Trade Agreements (CRTA) -- doesn't work. No examination reports have been finalized or adopted for any PTA negotiated and notified to the WTO since the WTO was established in 1995. This means that countries negotiating PTAs need not concern themselves with the possibility that their arrangement might not pass muster under WTO. If you don't have to be particularly worried about satisfying WTO criteria, why not negotiate a PTA?<sup>4</sup>

A fourth characteristic of WTO is its more limited scope and coverage. Although the Uruguay Round changed the GATT's scope and focus rather importantly with attention moving to behind the border regulatory issues addressed to health and safety standards, prudential regulation, conformity assessment procedures, government procurement and a host of other trade-related measures not covered by the GATT, a number of other trade topics of substantial interest to many Members have still to make their way onto the WTO agenda.

Probably a majority of recent PTA's – at least those involving at least one developed country partner – are "Third Wave" PTAs, the scope of which extends not only to GATT and WTO-era disciplines but also to areas not yet covered in the WTO system. Typically, the agreements include chapters on investment protection and right of establishment, competition policy (with competition policy in some cases replacing recourse to antidumping between the parties), government procurement (today still only a plurilateral agreement in the WTO), environmental protection and, in the case of agreements involving the USA, a chapter on respect for labor standards.

Intellectual property provisions in the agreements tend to be more extensive and updated relative to the WTO TRIPS Agreement. It is often also the case that the trade in services chapters of these third wave PTAs are based on a top-down negative list approach that can be far more extensive in its liberalizing effect than the bottom-up approach of the GATS. Today's limited scope of the WTO's

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<sup>4</sup> There is, of course, still the risk that the PTA, or elements of it, might be judged as to consistency with WTO as a consequence of a dispute settlement action.

coverage and many WTO Members' reluctance to expand this coverage are important incentives driving the negotiation of PTAs.

Of course, if the motivation for an agreement is essentially political, then the WTO's multilateral route is never a feasible alternative. Economic considerations certainly did not drive the negotiation of the U.S.-Israel, U.S.-Jordan or U.S. Morocco PTAs. The Mercosur agreement linking Brazil, Argentina, Uruguay and Paraguay is another example of a politically-motivated agreement<sup>5</sup>.

There are also political economy reasons to negotiate PTAs. The man and woman in the street tends to react rather well to mercantilist arguments. If one is trying to peddle a liberal trade regime and the multilateral system isn't cooperating, then demonstrating through a bilateral that others are making reciprocal "concessions" can be very helpful in bringing along the electorate.

On the dark side, a PTA may be grounded in an exclusionary motivation that will be neither welfare enhancing nor complementary to the WTO multilateral process as participants in such a PTA will have little interest in seeing progress at the multilateral level.

It is apparent that there are many reasons why governments today would find it expedient to negotiate trade liberalization through a PTA either (a) in place of; (b) prior to; or, (c) in tandem with trade liberalization at the multilateral level of the WTO. The underlying economic and political reasons unique to each PTA would most likely instruct us as to whether the PTA is likely to complement or undermine the multilateral system.

#### Ensuring Compatibility of PTAs with the WTO

There remains the very important consideration of ensuring the legal compatibility of PTAs with the WTO system.

In 1997, the Carnegie Endowment for International Peace sponsored a report<sup>6</sup> by a study group of eminent persons focused on the interaction of PTAs and the multilateral system. As I note in my paper, the Group finished its report with five policy recommendations, most of which contain elements with continued validity today. It can also be seen that many of the concerns expressed by the Study Group and reflected in their 1997 recommendations have found their way into the proposals submitted in the current Doha Round negotiations on the rules governing regional trade arrangements

My paper focuses on current aspects of three of the 1997 Study Group's policy recommendations: the need to strengthen compliance criteria in order to ensure that PTAs are consistent with the rules of the WTO; architecture and accession conditions of PTAs; and, how the WTO might use its institutional structure to promote compatibility between PTAs and the WTO.

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<sup>5</sup> In his chapter "Some Lessons from the Mercosur Initial Experience", Felix Pena writes: "The strategic objective of this political and economic process between nations of South America has been to create a common regional space in order to strengthen their own domestic efforts towards democracy consolidation, productivity transformation and competitive insertion in the global economy. ...Therefore it [Mercosur] cannot be conceived solely from an economic point of view. On the contrary, although it is a process with economic foundations and contents, it also has a clear political nature and consequences". Regionalism and Multilateralism after the Uruguay Round, European Interuniversity Press, Brussels 1997 p. 163.

<sup>6</sup> Reflections on Regionalism – Report of the Study Group on International Trade, Carnegie Endowment for International Peace, Washington, D.C. 1997. Members of the Study Group included Jaime Serra, Guillermo Aguilar, Jose Cordoba, Gene Grossman, Carla Hills, John Jackson, Julius Katz, Pedro Noyola and Michael Wilson.

In my comments now, I will limit my remarks to the first point – which really goes to the core of the debate anyway.

While a considerable number of proposals have been tabled by a wide range of countries on a large number of substantive and procedural issues, we can illustrate the difficulties associated with the current negotiations by reference to what is perhaps the central issue: how to define for the purposes of judging a PTA's legal compatibility with the WTO, the requirement that trade barriers be eliminated on "substantially all the trade" between the parties.

One might be tempted at this stage to say that this should be an intuitive concept – you know it when you see it -- but things are far from simple in the WTO. Not surprisingly, this core issue of the RTA part of the rules negotiations in the Doha Round has benefited from a number of delegation proposals. Also not surprisingly, negotiators are still some distance from an eventual agreement on this issue as illustrated by a sampling of the proposals received in the Negotiating Group.

Australia submits that "substantially all the trade" should be defined in terms of coverage by a free trade agreement or an agreement establishing a customs union of a defined percentage of all six-digit tariff lines listed in the Harmonized System."

Australia further elaborates that "such a percentage criterion should be established at a sufficiently high level to prevent the carving out of any major sector." Turkey argues that the qualitative approach that does not permit the exclusion of any sectors, or at least no major sector from the liberalization, is not politically realistic. India takes the position that "Members may like to define "substantially all the trade" for the purpose of GATT Article XXIV in terms of both (i) a threshold limit of the HS tariff lines at the six-digit level; and (ii) the trade flows at various stages of implementation of the RTA."

If there is anything clear from all of this it is the fact that until such central issues are resolved – in the WTO and through negotiations – the regular machinery of the WTO will remain incapable of addressing the basic legal compatibility of PTAs with the rules of the WTO. There should be a certain urgency to this exercise because – as noted above – if prospective PTA participants start from a presumption (as they would be currently entitled to have) that the consistency of their agreement with the WTO is unlikely to be judged, they will be free to pursue PTAs for the objective of pure discrimination against other Members of the WTO – and this could be a very negative thing, both for the health of the WTO and for economic welfare more globally.

Noted economist Richard Cooper makes the point that a continued failure to enforce the "substantially all trade" rule will normally mean that the exclusions from coverage will take place precisely in those sectors where trade creation is likely to be the most substantial – so that the more one backs away from the comprehensive requirement, the more likely the agreement is to involve trade diversion.

## Conclusions

On the general policy level, the world is unlikely to come to a consensus anytime soon on the question of whether or not PTAs assist, complement or undermine the multilateral system of the WTO. Probably no two PTAs are motivated by identical considerations and it is equally likely that no two WTO Members would have the same political and economic policy reactions to what might appear to be identical chapters in a modern PTA.

Former Director-General Ruggiero participates in an informal group called the "Shadow G-8" which every year produces a document for the leaders participating in the economic summit. This year, the Group's report included the following recommendation:

"The G-8 Leaders should reaffirm their commitment to give priority to the multilateral system, seeing any regional and bilateral agreements they pursue in that broader context and making sure that they structure those agreements in ways that are compatible with their global obligations. In addition, the leaders should agree that any Free Trade Agreements that they conclude will be comprehensive in scope, including agriculture, to assure their conformity with the WTO. They should also instruct their trade ministers to devise the most effective methods available ... to substantially strengthen the WTO rules that govern regional and bilateral agreements in order to ensure that they do not deviate importantly from the goals and precepts of the multilateral system."

Good advice. Clearly, we need to do everything that we can to create an effective WTO review of PTA consistency with the multilateral system. The fact that the CRTA process has broken down so completely is a major systemic loophole that needs to be closed –or at a minimum significantly narrowed. Economically, we know that PTA's can have negative effects, both nationally and globally. Politically, we know that PTA's motivated by the wrong reasons have the potential for undermining support for the WTO. At a minimum, governments should not add to the potential problem by continuing to be in the position that they are in today of not being able to say conclusively whether a PTA is consistent or not with the rules of the multilateral system.

As you can see from my final slide, although some of the issues are complex, the inescapable conclusions I reach are fairly straightforward.

Preferential trade agreements are increasing in number and in popularity and this is due in part to built-in disincentives for pursuing trade liberalization through the WTO system.

The WTO surveillance system is broken. And this is a real problem.

Finally, even committed multilateralists probably have to conclude that the current flood of PTA activity is probably not reversible. This puts the onus on us to ensure that the multilateral system has an effective mechanism to ensure the compatibility of PTAs with the WTO. Otherwise, their long term political and economic effects are likely to be negative – both globally and from the standpoint of national economic welfare.

I hope that I have made a worthwhile contribution to this important conference. Thank you very much for your attention.