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**IS THE INTERNATIONAL TRADING  
SYSTEM FRAGMENTING?  
THE DILEMMA FOR AUSTRALIA  
TRADE POLICY**

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## **Is the international trading system fragmenting? The dilemma for Australian trade policy**

### ABSTRACT

The post-World War II international trade policy framework is being challenged by a proliferation of bilateral and regional trading arrangements. Australia faces a choice over whether to join this preferential trade bandwagon and risk collateral damage to the multilateral trading system, or to go no further down the preferential trade road but risk being “left behind” in the event that the rush to PTAs continues, leaving the multilateral system increasingly sidelined.

JEL classification: F2, F13

Key words: Globalisation, international trade, trade policy

## **Is the international trading system fragmenting? The dilemma for Australian trade policy.**

### **Introduction and summary**

An important area of research interest for the Lowy Institute is the emerging debate on whether we are living through a fundamental change in Australian foreign policy and whether this change has been driven by a marked shift in how the world works. Part of this debate therefore involves a discussion of how developments in the international economic environment affect Australia's place in the world. This paper focuses on one part of that external economic environment – the international trading system – with a particular emphasis on the implications of the rise of preferential trading agreements (PTAs). This trend is identified both as a response to the challenges facing the current trading framework and as a source of pressure on that framework. The potential costs and benefits of the recent rise in regional trading agreements are reviewed and some policy implications highlighted.

The paper begins by reviewing the achievements of the current international trading system. It notes that the post-World War II trade policy framework – based around multilateral trade liberalisation under the auspices of the General Agreement on Tariffs and Trade (GATT) and its successor the World Trade Organisation (WTO) – has helped deliver a sustained period of rapid growth in trade flows and international economic integration, an achievement that has been described as “perhaps the most successful exercise of deliberate economic policy making in history”. Despite these successes, however, the trading system faces growing challenges. The paper identifies several strains, including changing relative economic performance among the leading industrial nations and new protectionist pressures that have been thrown up by the deepening penetration of international trade into national economies. In addition, it notes that the ending of the Cold War has also started to alter the political cost-benefit calculations for a US economy which until now has provided substantial economic and political support for the post-war trading framework.

The paper then describes how one response to the challenges facing the international trading system has come in the form of a proliferation of bilateral and regional trading arrangements – the so-called “New Regionalism”. The growth in the number of these PTAs has been dramatic. Between 1948 and 1994 the GATT received notifications for 124 agreements. In contrast, since the creation of the WTO in 1995, more than 130 additional agreements have been notified. As a result, around 43% of world merchandise trade now takes place within preferential agreements and the WTO has estimated that more than half of global trade could be occurring within such agreements by 2005. The paper notes that the spread of this New Regionalism to East Asia is of particular significance for Australian policymakers, as major trading partners such as Japan and Korea have now abandoned a previous disdain for PTAs and have signalled that they intend to join the global trend.

The paper provides a brief review of economic theory and empirical evidence on the merits of PTAs and concludes that neither provides an unequivocal answer as to whether they are good either for member economies or for the world trading system as a whole.

Finally, the paper concludes by identifying the dilemma for Australian trade policy created by the PTA bandwagon. As a medium-sized open economy Australia has a vital national interest in the ongoing health of the multilateral trading system. Any gains from individual PTAs would look insignificant when set against the costs involved in a fragmenting global trading system. The dilemma for policymakers therefore is whether to continue to push ahead with PTAs like the current free trade agreement with the United States, and hence risk collateral damage to the multilateral trading system, or to go no further down the preferential trade road, and take the chance of being “left behind” in the event that the rush to PTAs continues, leaving the multilateral system increasingly sidelined.

## **Is the international trading system fragmenting? The dilemma for Australian trade policy.**

*“Our increasing integration into the global economy and the prosperity that flows from it depend vitally on stable and open rules and arrangements that protect and promote our flows of trade and finance.”*

Department of Foreign Affairs and Trade<sup>1</sup>

*“No country is immune from the effects of regionalism as it shapes world economic and political relationships and influences the development of the multilateral trading system, and all countries face policy choices concerned with regionalism.”*

World Bank<sup>2</sup>

### **Australian trade policy and the changing international economic environment**

The recent White Paper on trade and foreign policy emphasises that “Australia’s prosperity has always depended on its international economic links”.<sup>3</sup> It recognises that Australia has done well from the existing international trading system, noting that “Australia has been a beneficiary and a strong supporter of the multilateral economic and trade institutions created to promote economic recovery following the Second World War. They have underpinned the global economic growth and prosperity of the past fifty years”. What’s more, these “global trade rules are becoming more important as globalisation deepens.”<sup>4</sup> But the same White Paper goes on to warn that the international economic environment facing Australia is changing, and that as a result, institutions such as the World Trade Organisation (WTO), which have maintained and developed the rules of the game for world trade, are facing growing challenges. As part of the policy response to this shifting external environment, the White Paper makes a case for Australia’s supplementing its reliance on the multilateral trade framework with new bilateral and regional trading arrangements.

The White Paper is certainly correct in recognising that the international trading system is undergoing significant changes, albeit not for the first time. The post-World War II trade policy framework – based around multilateral trade liberalisation under the auspices of the General Agreement on Tariffs and Trade (GATT) and its successor, the WTO – is widely credited with having helped deliver a sustained period of rapid growth in trade flows and international economic integration. In part that system has been sustained by the economic and political leadership role played by a US economy strongly committed to the principles underlying the multilateral system. Over time, however, changing relative economic performance has placed this commitment under increasing pressure, while the end of the Cold War has arguably altered political and economic calculations regarding the benefits of the current rules of the game. Moreover, the continued process of international economic integration has itself produced new challenges for the current system. As international trade has penetrated ever further into national economies, it has created new areas of dispute and new constituents for protectionism, with demands for trade to be regulated on environmental grounds or for reasons of “fair trade”.

The White Paper is also correct when it notes that bilateral and regional trading agreements have been one response to this changing international environment. Unfortunately the policy implications of this particular development are complicated. This is highlighted by the way in which the multiplication of such agreements over the past decade can be cited in support of two competing views about the probable direction of the international economy in the post-Cold War era. One sees a process of continued international economic integration fuelled by sustained technological progress and further economic liberalisation. The other fears that rising national and regional rivalries will result in the fragmentation of the international trading system into competing economic blocs. Proponents of bilateral and regional trading arrangements claim that they complement rather than replace the existing multilateral trade framework, and herald further – and deeper - international economic integration.

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<sup>1</sup> Department of Foreign Affairs and Trade (2003)

<sup>2</sup> World Bank (2000)

<sup>3</sup> According to the White Paper, Australian exports as a share of GDP stood at 22% in 2001-02 (up from 11% in 1981-82) and about one in five jobs is estimated to be related either directly or indirectly to exports.

<sup>4</sup> Department of Foreign Affairs and Trade (2003)

Critics charge that they disrupt the international trading system and undermine the case for global free trade, even risking a return to the competing trading blocs of the interwar period. According to the World Bank, the growth of preferential trading agreements is “one of the major international relations developments of recent years”.<sup>5</sup>

### The origins of the post-war trading system

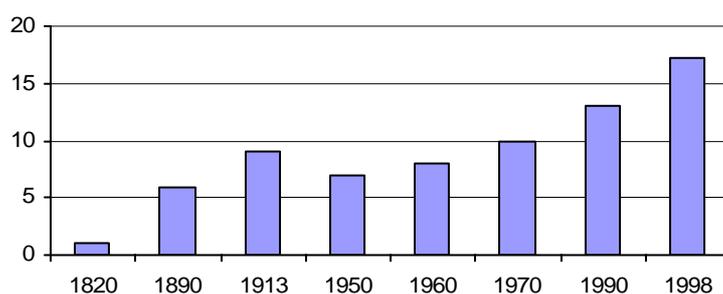
Shifts in the international trading system are nothing new; the policy framework within which trade issues are managed, and the process of trade integration itself, have both passed through several distinct transformations over the past century.

Indeed, by the end of the nineteenth century, the world economy was already in the midst of what has been called the first age of global capitalism. The period between 1870 and 1913 saw a rapid expansion in international trade, with annual growth in world exports (3.5%) running well ahead of real GDP growth (2.7%). The share of exports in world output rose steadily over this period and reached a peak on the eve of the First World War that would not be exceeded until the 1970s.<sup>6</sup> The bulk of this increase in trade flows looks to have been driven 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. In addition, trade flows were supported by a relatively stable financial and political environment (at least for the major economies) provided by the gold standard and guaranteed by the *Pax Britannica*. Notably, however, trade *policy* does not appear to have played a particularly positive role in boosting trade flows over this period. Indeed, after 1879 the introduction of tariffs by Germany, followed by several other major economies, meant that protectionism actually *increased* at this time.<sup>7</sup>

The outbreak of World War I brought this first age of global capitalism to an abrupt end. The interwar years that followed 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. By the 1930s the rise of protectionism meant that quantitative restrictions affected between 50% and 70% of world trade.<sup>8</sup> As the international trading system fragmented, world trade contracted even faster than global output, pushing activity into a downward spiral that contributed to growing economic dislocation and rising political extremism, leading the world into the “dark valley” that culminated in World War II.<sup>9</sup>

### Global openness in historical perspective

World merchandise exports, % of GDP



Sources: Crafts (2000) and Maddison (2001)

Memories of the economic and political instability experienced during the interwar years meant that Allied – primarily US – policymakers saw the restoration of a functioning, integrated international economy as a key priority for the post-World War II reconstruction effort. A co-operative effort to reduce barriers to international trade was seen as a major part of this process, and hence even while the

<sup>5</sup> World Bank (2000)

<sup>6</sup> Masson (2001)

<sup>7</sup> Krugman (1995), International Monetary Fund (1997), International Monetary Fund (2002)

<sup>8</sup> Crafts (2000)

<sup>9</sup> Brendon (2001)

war was still under way US policymakers were planning for a post-war world in which trade liberalisation would be supported by a set of rules laid down within a multilateral policy framework.<sup>10</sup> These ideas were given formal expression in December 1945 when the US State Department published its *Proposals for the Expansion of World Trade and Employment*, which called for the creation of an International Trade Organisation (ITO).<sup>11</sup> This institution was intended to complement the other Bretton Woods institutions – the International Monetary Fund (IMF) and the World Bank – in helping to manage the global economy. The concept of an ITO was accepted in principle by more than 50 countries, which were then involved in discussions on a charter for the new organisation.

### The GATT/WTO framework<sup>12</sup>

While discussions on the charter were still underway, 23 economies – at that time accounting for more than three-quarters of world trade – decided in 1946 to push ahead with trade liberalisation in advance of 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 and the 23 countries became founding members (formally, contracting parties). When the US Congress refused to ratify the ITO Charter in 1950 and effectively destroyed the ITO, the GATT was left as the only multilateral framework governing world trade. The GATT then continued to fulfil this role from 1948 until 1994, when it was succeeded by the WTO.

Chronology of key developments in GATT/WTO <sup>13</sup>	
1947	First Geneva Round. Tariff reductions of about 20% negotiated and GATT terms agreed. ITO charter drafted.
1948	GATT provisionally enters force
1949	Annecy Round. Accession of 11 new contracting parties. Tariff reductions of about 2% negotiated
1950	US Senate rejects ITO proposal.
1950-51	Torquay Round. Accession of 7 new contracting parties. Tariff reductions of about 3% agreed.
1955-56	Geneva Round. Tariff reduction of about 2.5%.
1960-61	Dillon Round. Tariff reduction of about 4%.
1964-67	Kennedy Round. Tariff reductions of about 35%.
1973-79	Tokyo Round. Tariff reductions of about 33%.
1986-94	Uruguay Round. Additional tariff reductions. New agreements on agriculture, clothing, services, investment, intellectual property rights and dispute settlement.
1995	WTO established
2001-?	Doha Round. Originally due for completion by January 2005.

The GATT was set up to make “trade flow as freely as possible – so long as there are no undesirable side effects.”<sup>14</sup> This objective was to be pursued through a multilateral system based on negotiation

<sup>10</sup> “By 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.” Irwin (2002)

<sup>11</sup> Irwin (2002)

<sup>12</sup> The following section draws on material from World Trade Organization (1997)

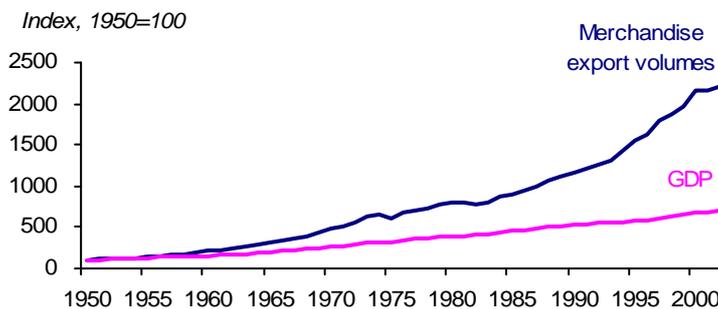
<sup>13</sup> Sources: Table 2.1 in Gilpin (2000) and Table 5.3 in Irwin (2002)

and reciprocity, and was to rest on several core principles. Chief among the latter would be a requirement that the international trading system should be *non-discriminatory*; that a country should not discriminate against its trading partners but rather should treat all GATT/WTO members equally (the most-favoured nation principle, or MFN, which is embodied in Article I of the GATT); and similarly should not discriminate between its own and foreign products (the principle of national treatment, embodied in Article III). In addition, the rules of the game should be designed to ensure that the international trading system be made as predictable and transparent as possible.

The initial focus of the GATT was on industrial economies and their trade in manufactured products, and between 1947 and the 1980s the agreement presided over a sustained reduction in industrial country tariffs on manufactured goods. As a result, by the late 1980s industrial countries' tariffs on manufactures had fallen to around 6%, and they had dropped to almost 4% by 1999. This GATT-led trade liberalisation took place within several rounds of trade negotiations – of which eight have been completed to date, with a ninth (the Doha Round) currently under way. These successive rounds of trade liberalisation have been described as “perhaps the most successful exercise of deliberate economic policy making in history.”<sup>15</sup>

However, progress under these trade rounds showed signs of becoming increasingly difficult, as evidenced in the successively longer time taken to reach agreement. Thus, while the Kennedy Round ran from 1964 to 1967, the Tokyo Round lasted from 1973 to 1979, and the Uruguay Round took seven and a half years, lasting from 1986 to 1994 (almost twice the original schedule). Reasons for this rise in negotiating time included the increasing complexity of global trade, the spread of trade to new areas (such as services), and the need to deal with contentious issues such as agriculture, clothing and textiles that had not been dealt with by the original agreement. It also reflected the growing membership roll of the GATT/WTO; while only the 23 original signatories participated in the Geneva round in 1947, 102 countries took part in the Tokyo round and 123 countries in the Uruguay round.

### World output and trade in the postwar period



Source: World Trade Organization (2002)

The Uruguay Round “brought about the biggest reform of the world’s trading system since GATT was created” and culminated in the creation of the WTO.<sup>16</sup> Unlike the GATT, which never managed to become a fully-fledged international institution along the lines of the IMF or World Bank, the WTO was granted the status of a formal international organisation. While the WTO replaced GATT (the international agency) the GATT agreement itself (GATT 1947) remained, albeit supplemented and updated to be incorporated into the new WTO agreement. This ‘new’ GATT (GATT 1994) was then installed alongside a General Agreement on Trade in Services (GATS) and an Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS), so that all three areas could be managed within a single organisation.<sup>17</sup>

<sup>14</sup> World Trade Organization (1997)

<sup>15</sup> Ethier (1998)

<sup>16</sup> World Trade Organization (1997)

<sup>17</sup> Another change was that under the WTO the old GATT dispute system was to be strengthened by increasing the speed and automaticity of the process.

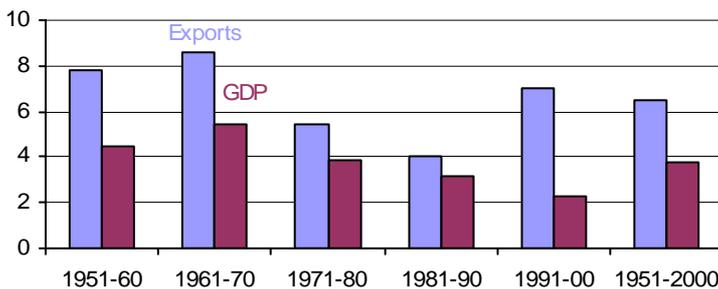
## Growing world trade

In the post-war era, global trade growth has consistently run ahead of global output growth. Between 1951 and 2000 export volumes rose at an annual rate of around 6.5%, while GDP grew at a rate somewhere below 4%.

The gap between trade and output growth rates has varied over time. Thus world trade grew at around 3% a year faster than output in the 1950s and 1960s, 2% a year faster in the 1970s and 1% a year faster in the 1980s. As a result, while international integration – measured by a rising share of trade in output – continued throughout this period, the process also showed signs of slowing through the 1970s and 1980s. The latter appears to have been due in part to a combination of declining momentum for trade liberalisation and a diminution in the rate of fall of transport costs.<sup>18</sup>

### Global trade growth has outpaced GDP growth

Average annual growth rate, %



Source: Asian Development Bank (2002) and WTO (2001)

By the 1990s, however, trade volume growth was again significantly outpacing growth in global output, contributing to a further increase in the measured openness of international economies. This continued until 1998, when world trade growth fell sharply as a consequence of the Asian financial crisis and a more general slowdown in global growth.<sup>19</sup>

### Did the multilateral system boost world trade growth?

It is fairly widely accepted that the rapid growth of the world economy since World War II has been driven at least in part by progress with trade liberalisation.<sup>20</sup> According to the WTO, for example, the data show a “definite statistical link between freer trade and economic growth”, and the organisation claims that the process of GATT-led tariff reduction has contributed to continuing economic integration in the post-war world.<sup>21</sup>

Krugman identifies two main explanations for the growth in world trade in the post-war era: a “journalistic” view which explains integration as driven by improvements in transport and communications technology, and the view of “international economists” which, although granting some role for technological explanations, “points to the role of the GATT and . . . unilateral liberalising measures by developing countries”. The latter tends to see “the growth of trade as having essentially political causes, seeing its great expansion after World War II largely as a result of the removal of . . . protectionist measures”.<sup>22</sup> Other explanations that have been advanced for rapid trade growth over this period include real income growth, the convergence of countries’ incomes and increased vertical specialisation and outsourcing.<sup>23</sup>

Krugman’s second explanation is “political” because it involves the participation of policymakers within a set of international trading rules. But this begs the question of how that framework was built

<sup>18</sup> Summers (1991)

<sup>19</sup> International Monetary Fund (1999)

<sup>20</sup> International Monetary Fund (2001)

<sup>21</sup> World Trade Organization (1997)

<sup>22</sup> Krugman (1995)

<sup>23</sup> Feenstra (1998)

and enforced. One possibility is that the rules of the game could emerge naturally, through the repeated interaction of economic interests. But a more compelling view is the hypothesis that a significant share of post-war international integration has relied on “hegemonic stability.” The proposition here is that provision of global public goods like free and open markets requires leadership by a dominant power – Britain at the end of the nineteenth century, and the US in the post-war era.<sup>24</sup> For example, Gilpin argues that, “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”.<sup>25</sup>

One attempt to quantify the relative importance of at least some of these explanations can be found in work by Baier and Bergstrand which examines bilateral trade flows between 16 OECD countries from the late 1950s to the late 1990s.<sup>26</sup> Their results indicate that income growth explained about 67% of the growth in average trade flows over this period, tariff reductions about 25%, transport costs about 8% and income convergence virtually zero. Hence they find that tariff reductions were roughly three times as important as declining transport costs in boosting trade flows in the post-war era.

Not all economists are convinced that the GATT/WTO framework itself has been a decisive force for rapid trade growth, however. An empirical study of the effect of the post-war multilateral agreements on trade by Andrew Rose concludes “that it is surprisingly hard to demonstrate convincingly that the GATT and the WTO have stimulated trade”.<sup>27</sup> He finds that once his model of trade takes into account standard explanatory factors such as economic distance and output, this leaves no room for a positive effect on trade flows for GATT/WTO membership.<sup>28</sup> These findings clearly pose some questions for the conventional wisdom about the benefits of the multilateral system.<sup>29</sup>

However, there are reasons to view these results with caution. Patrick Low, director of economic research at the WTO, argues that the WTO’s system of rules and its dispute settlement mechanisms have effects on trade policy that won’t necessarily show up as changes in trade flows clustered around a GATT/WTO accession date, making them difficult to detect in the kind of modelling exercise conducted by Rose.<sup>30</sup> A related complication is that many countries did not immediately liberalise their trade regimes upon joining the GATT/WTO, but instead did so gradually.

Rose’s findings have also been called into question by other econometric research. A recent IMF working paper refines Rose’s work and 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.”<sup>31</sup> The authors focus on the fact that for much of its life the WTO/GATT concentrated on the liberalisation of industrial country trade, with developing countries left largely exempt from its requirements until the Uruguay Round. They find that once this differential treatment is taken into account, WTO/GATT membership can be shown to have contributed significantly to boosting industrial country imports.

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<sup>24</sup> Eichengreen (2001)

<sup>25</sup> Gilpin (2000)

<sup>26</sup> Baier and Bergstrand (2001)

<sup>27</sup> Rose (2002)

<sup>28</sup> The explanatory factors come from the gravity model of international trade – probably the mostly 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 (2002).

<sup>29</sup> In contrast, Rose finds that the Generalized System of Preferences (GSP) – by definition a *preferential* form of trade support - *does* have a strong positive effect on trade volumes.

<sup>30</sup> Low (2002)

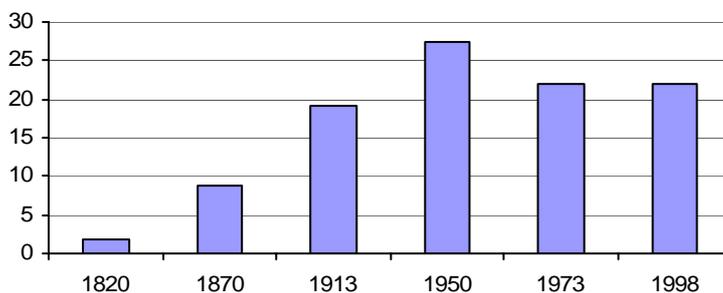
<sup>31</sup> Subramanian and Wei (2003)

## The international trading system under pressure

Despite the positive association of the post-war multilateral trading system with increasing trade flows and faster economic growth, that system has been under growing pressure, as evidenced most recently in the collapse of the September 2003 ministerial meetings in Cancún. Several factors have been at work, but in particular, to the extent that the system has relied on US economic and political leadership – the *Pax Americana* – any weakening in US commitment to that system has been seen as especially problematic. While commitment to a multilateral system had been a “central feature of US trade policy” in the early post-war years, there were signs by the early 1980s that the commitment was wavering.<sup>32</sup> Krugman for instance 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 economic decline of the US (measured by its falling share in world GDP) meant that Washington was “losing both the means and the desire to serve as global trade hegemon.”<sup>33</sup>

### US economic power in historical perspective

US GDP as % of world GDP



Source: Maddison (2001)

It does seem likely that a significant factor behind a changing US view on the relative merits of the multilateral system was economic. The strong support for a liberal trading regime that had been part of early post-war US policymaking was perhaps eroded by increasing fears of foreign competition deriving from changing patterns of comparative advantage and economic catch-up in the rest of the world.<sup>34</sup> It certainly appears to be the case that the rise of Japan and the concomitant relative decline in US economic power helped encourage the so-called ‘New Protectionism’ of the 1970s, epitomised by Section 301 of the 1974 US Trade Act, which allowed action against ‘unfair’ trading practices.

These economic pressures may have subsequently been reinforced by political developments. In particular, the ending of the Cold War will have had some effect on the political cost-benefit calculations of policymakers – perhaps undermining the US’s “ability and willingness to pay the economic and other costs of world economic leadership”.<sup>35</sup> With the Cold War over, policymakers were more inclined to focus on economic security, a preoccupation that was reinforced by the steady rise of East Asia as a global trading and manufacturing power, and the associated fears about “deindustrialisation” in the older industrial economies. The rise of China as a great trading nation is just the latest – albeit potentially most dramatic – phase in this process.<sup>36</sup>

In addition, however, US policymakers also became concerned that trade liberalisation under the multilateral framework had “stalled.”<sup>37</sup> Critics of the WTO charged that securing a consensus was becoming steadily more difficult and time-consuming. In part, this reflected the increase in membership already noted above – in itself a mark of success. When the GATT came into effect in

<sup>32</sup> Irwin (2002)

<sup>33</sup> Krugman (1991)

<sup>34</sup> Crafts (2000)

<sup>35</sup> Gilpin (2000). But note that the ending of the Cold War is also associated with a period of increased liberalisation, as developing economies and former Communist countries joined the trading system and – frequently unilaterally – lowered trade barriers.

<sup>36</sup> Parallel changes in the cost-benefit calculus would have applied to policymakers in other industrial countries, in particular in the EU with its focus on the Single Market project.

<sup>37</sup> Irwin (2002)

1948 it had 23 signatories. By early April this year the WTO had 146 members (between them accounting for about 90% of world trade), with a further 25 countries in the process of negotiating accession. There were also institutional factors at work. For example Schott and Watal note that contracting parties under the old GATT system could “free ride” on agreements, in the sense that while the major industrial economies drove the GATT agenda, they did not insist on full participation by all countries. But under the WTO regime, member countries are required to participate in all of the negotiated agreements as part of a “single undertaking”, meaning that more countries now have a vested interest in the outcome of negotiations. Schott and Watal argue that the combination of this change with the increase in membership significantly complicated – and hence slowed – the decision-making process.<sup>38</sup>

With US policymakers also increasingly aware of the EU’s moves towards closer regional integration, Gilpin points to a resultant US “shift from multilateralism to unilateralism” during the Reagan administration. This involved the introduction of a “multi-track” trade policy and commitment to regional trade agreements such as the 1983 Caribbean Basin Initiative, the 1985 US-Israel free trade agreement (FTA) and the US-Canada FTA (CUFSTA) in 1988, followed by the North American Free Trade Agreement (NAFTA) in 1994.<sup>39</sup> Furthermore, the Bush administration argued that NAFTA should be a step towards a Free Trade Area of the Americas (FTAA).

The past decade has sent contradictory signals on some of these issues. On the one hand, the IT-driven boom in the US – along with stagnation in Japan and sluggish growth in Europe – has assuaged some of the US’s earlier fears about relative economic decline.<sup>40</sup> At the same time, the end of the Cold War has spurred a process of economic liberalisation in transition economies and coincided with a burst of reform in emerging markets that saw both sets of countries increase their participation in the international trading system.

On the other hand, the increasing spread of international trade into ever more areas of national economies has created new tensions and new advocates for protectionist measures. In particular, international competition has spread to areas that were previously considered “non-tradeables”, such as services. For example, the US IT industry has started to produce “protectionist rumblings” in response to the trend to outsource to Indian IT services, and several US states have moved to introduce legislation that seeks to ban IT outsourcing.<sup>41</sup> The increasing politicisation of trade policy has also been evident in the rise of the “New Trade Agenda” which, with its focus on labour standards, human rights and the environment, has brought growing questioning of the benefits of globalisation, and has threatened to undermine any pre-existing political consensus in favour of free trade. In this light, the 1999 protests at Seattle have been described as a “crucial watershed in the politics surrounding the global economy”, marking the first significant public protests against globalisation.<sup>42</sup>

The failure of the WTO to agree to a new round of negotiations at the Ministerial Meeting in Seattle in 1999 undoubtedly reinforced perceptions that the trading system was in trouble. Those perceptions have been further reinforced by the collapse at Cancún earlier this year. Indeed, the current Doha round was arguably only resurrected in response to widespread fears that the September 11 terrorist attacks would derail globalisation and damage the global economy. President Bush advanced the argument that the Doha Round should be seen as part of the US war on terror – presumably by helping remove economic grievance as a source of future terrorist recruitment. Still, this renewed US interest in the multilateral framework also has to be set against the current administration’s apparent predilection for unilateral actions, as well as a strong current of thought in the US that seems mistrustful of any international agreements that limit the sole superpower’s room for manoeuvre.

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<sup>38</sup> Schott and Watal (2000)

<sup>39</sup> Gilpin (2000)

<sup>40</sup> Whether this will continue to be the case in the aftermath of the bursting of the 1990s stock market bubble remains to be seen.

<sup>41</sup> Roach (2003)

<sup>42</sup> Gilpin (2000)

## The “New Regionalism” and the rise of preferential trading agreements

The pressures on the multilateral trading system have been matched (and critics would charge, exacerbated) by a growing move towards preferential trade agreements (PTAs) in the form of bilateral and regional agreements.

Regionalism is not an entirely new phenomenon on the global stage. The 1950s and 1960s witnessed a series of regional integration initiatives, although, with the exception of the European Community, these had little lasting impact.

By the late 1980s however, the drive by the EU to complete its internal market and the decision of the US and Canada to negotiate a free trade agreement prompted a renewed burst of regional integration that has been described as the “new regionalism” and which has continued to gain momentum through the end of the last century and into this one.<sup>44</sup>

One new feature of this wave of agreements is the rise of cross-regional PTAs; around one-third of agreements currently under negotiation are among countries belonging to different geographical regions.<sup>45</sup>

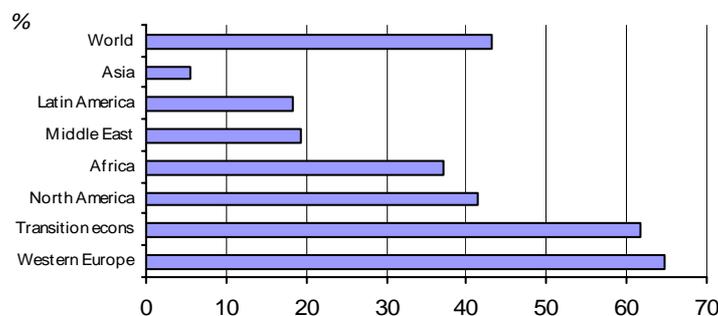
One result of the new regionalism is that around 43% of world merchandise trade now takes place within PTAs. The WTO estimates that this could rise to over 51% by 2005, as rapid growth in regional trade initiatives develops “into a headlong race”.

### What is a PTA?

In this paper we follow the WTO and define a PTA as an intergovernmental treaty through which signatories agree to offer more advantageous conditions in the conduct of their trade relations than those that will be applied to other, non-signatory WTO members.

Under this definition, PTAs can cover agreements between two economies (bilateral trade agreements), groups of economies in the same geographical region (regional trade agreements) and/or agreements between countries in geographically distant regions. PTAs can take the form of free trade agreements (FTAs), customs unions, common markets and economic unions. At present, FTAs account for about 90% of all PTAs.<sup>43</sup>

### Preferential trade as share of merchandise imports



Source: WTO (2003b)

The recent acceleration in the number of PTAs is also striking. Between 1948 and 1994 the GATT received 124 notifications of PTAs. Since the creation of the WTO in 1995, more than 130 additional agreements have been notified. As a result, by the end of 2002 a total of 259 PTAs had been notified to GATT/WTO (only 176 of these were then in force, while an additional 70 are estimated to have been operational but not yet notified). If PTAs reportedly planned or already under negotiation were to be concluded, the WTO reckons the number of such agreements could soon approach 300.

The spread of PTAs across the WTO membership is also notable. By March 2003 only four WTO members (Hong Kong, Macau, Taiwan and Mongolia) were not already party to a PTA, and of these only Mongolia was not engaged in some kind of PTA-related negotiation.<sup>46</sup>

<sup>43</sup> World Trade Organization (2001) and World Trade Organization (2003a)

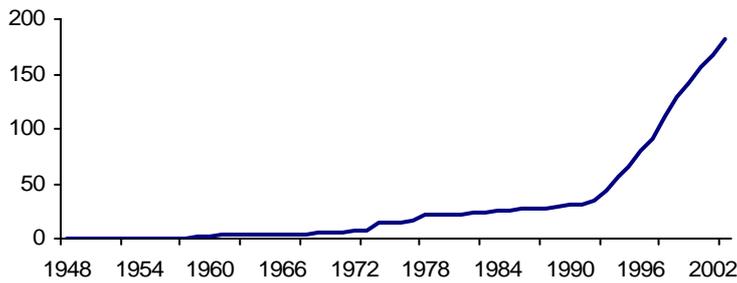
<sup>44</sup> Ethier (1998)

<sup>45</sup> World Trade Organization (2003b)

<sup>46</sup> World Trade Organization (2003b)

## RTAs currently in force

No. of RTAs by date of entry into force



Source: WTO web site

According to the WTO, PTAs are now a “major force” in global trade negotiations, and are contributing to the emergence of a “multi-tiered global trading system”. The organisation has expressed concern that this could create regulatory confusion and distort regional markets. And while the WTO is willing to concede that PTAs *can* work as a complement to the multilateral trading system, it also worries about the fact that by definition they are discriminatory trade agreements, and hence represent a departure from the key MFN principle (see the box below).<sup>47</sup>

Why has the recent growth in PTAs been so dramatic? Part of the story must be that they are a response to the pressures facing the multilateral trading system outlined above. But in addition it seems likely that the recent surge in such agreements reflects a self-reinforcing dynamic. This could simply be the positive demonstration effect arising from non-member economies seeing successful PTAs like the EU at work. But it could also be a response to fears of being excluded from the changing world trading system. Potential costs of non-membership in a world increasingly dominated by PTAs include the risk of trade and investment diversion.

### PTAs and the GATT/WTO

Although PTAs clearly violate the GATT/WTO ideal of non-discriminatory trade within a multilateral framework, the GATT’s articles do allow signatories to participate in regional agreements, provided that they meet certain conditions.

These conditions are set out in Article XXIV of the GATT.<sup>48</sup> These include requirements that PTAs must not “on the whole” lead to an increase in protection against non-members; they should reduce internal tariffs to zero and remove “other restrictive regulations” except those justified by other GATT requirements; and they should cover “substantially all trade”.

The WTO says that PTAs should ideally be formed within the spirit of article XXIV, which in effect requires members to use PTAs to promote deeper trade liberalisation and integration while continuing to push for multilateral trade liberalisation. But it warns that not all PTAs meet the spirit of these requirements. The WTO also concedes that the “WTO surveillance mechanism for the formation of [P]TAs is, to a large extent, non-operational.” 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 (e.g. on preferential rules of origin), or from discrepancies between WTO rules and those contained in some [P]TAs.”<sup>49</sup> The World Bank makes a similar assessment, noting that because the wording of Article XXIV is fairly ambiguous – the definitions of “on the whole” for example, or “substantially all trade” are open to a significant degree of interpretation– that the WTO’s requirements for PTAs are “notoriously weakly enforced”. As a result, in the Bank’s judgement WTO rules on PTAs “are not exactly broken, but they are creaking”.<sup>50</sup>

<sup>47</sup> World Trade Organization (2003a) and World Trade Organization (2003b)

<sup>48</sup> The following summary draws on work in World Bank (2000)

<sup>49</sup> World Trade Organization (2003b)

<sup>50</sup> World Bank (2000)

A related possibility is that membership is motivated by fear of being isolated in the event of international trade disputes. Whalley, for example, has argued that this contributes to a strong “insurance motive” for being inside a large PTA.<sup>51</sup>

The current angst in New Zealand over the possible economic costs of an Australia-US free trade agreement can be seen as an example of these kinds of concerns at work.

Baldwin has used the term “domino regionalism” to capture the way in which bandwagon effects could come into play whereby an increase in the number of PTAs encourages still more economies to join existing PTAs or create their own agreements.<sup>52</sup> As an example of this process, he highlights the case of three Scandinavian economies which he argues joined the EU because of economic pressures, despite having significant political misgivings. The WTO has also expressed fears that the new regionalism could be generating bandwagon effects as economies come to believe that PTAs are necessary to protect market access.<sup>53</sup>

### **PTAs in theory**

Does economic theory provide any guidance as to whether the recent proliferation of PTAs is a positive development? Unfortunately, while there is a broad consensus among economists that a move toward global free trade will be positive for overall economic welfare, there is no such agreement about the possible benefits of PTAs. In the terminology made popular by Robert Lawrence, economists are divided as to whether PTAs are building blocks to freer world trade or stumbling blocks.<sup>54</sup>

In a review of the arguments for and against PTAs, Krueger begins by noting that economists have tended to distinguish between two separate questions relating to such agreements.<sup>55</sup> The first asks whether PTAs promote net welfare gains in member and non-member economies, while the second asks how the functioning of PTAs affects the multilateral trading system. While the second is generally agreed to be the more important question, it also seems to be harder to answer. As a result, more attention has been focused on the first question.

The original finding that the impact of PTAs on economic welfare is ambiguous dates from Viner’s work on customs unions, which introduced the concepts of *trade creation* and *trade diversion*.<sup>56</sup> Viner’s insight was that a PTA could either increase or reduce economic welfare, depending on which of the two effects dominated.

The ambiguity is a function of the discriminatory nature of PTAs.<sup>57</sup> Consider three economies that all produce widgets. Assume that in Australia the cost of producing a single widget is \$8, in the US it is \$6 and in Korea \$4. Assume also that Australia currently imposes a tariff on all imports of widgets to protect the domestic widget industry. If Australian policymakers decided to cut all barriers to trade in widgets on a non-discriminatory (multilateral) basis, Australian welfare would be improved by giving the economy access to cheap Korean widgets. But what if instead Australia and the US enter into a PTA? There are two possibilities. If Australia’s initial tariff on widgets was set such that it excluded both Korean and US imports (for example if Australia had set a tariff of \$5 per widget), then a reduction of the tariff on US widgets would lead to a welfare gain for Australia by giving the economy access to a more competitive supplier. But if the initial tariff on widgets was set at \$3 so that Australia was importing Korean widgets, then after the PTA Australia will switch to importing US widgets. The PTA has then introduced a distortion by moving demand away from the lowest-cost producer.

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<sup>51</sup> Whalley (1996)

<sup>52</sup> Baldwin (1995)

<sup>53</sup> This concern is also highlighted in the White Paper on trade policy, as discussed below.

<sup>54</sup> Lawrence (1991)

<sup>55</sup> Krueger (1999)

<sup>56</sup> Viner (1950)

<sup>57</sup> The following example is derived from a similar one in Krugman and Obstfeld (1991)

In summary, Australia will gain from the PTA if it is *trade-creating* (US widgets replace higher cost domestic widget production) but loses if it is *trade-diverting* (US widgets replace lower cost Korean widget production).<sup>58</sup>

This is an example of the theory of the second best, which says that in the presence of multiple distortions, removing only some of them will not necessarily be welfare-enhancing. In the case above, Australia has in effect two discriminatory policies in place – a tariff on US widgets and a tariff on Korean widgets. The tariff on US widgets actually helps offset the distortion created by the tariff on Korean widgets, so removal of the tariff could potentially reduce welfare.

Successive work on the theory of PTAs has attempted to refine Viner's original results.

- Meade showed that the higher the level of general tariffs before the introduction of a PTA, the greater the likelihood of trade diversion.<sup>59</sup>
- Lipsey posited that when PTAs bring together countries that are already major trading partners the probability of trade diversion is likely to be lower.<sup>60</sup>
- Summers has argued that trade creation is likely to exceed trade diversion when transportation costs are low.<sup>61</sup>

While the trade creation/trade diversion distinction has been the usual starting point for evaluating PTAs, it is not the end of the story. Other effects include the removal of consumption distortions and an improvement in members' terms of trade (at the expense of the rest of the world). Importantly, once the (realistic) possibility of an environment characterised by imperfect competition is introduced into the analysis, the welfare calculations of PTAs become more complex. For example, under these circumstances creation of a PTA could lead to a shift in the destination of the economic rents that accrue to imperfectly competitive industries.<sup>62</sup> Probably the most significant issue raised by allowing for imperfect competition is the potential for PTAs to allow increased market and firm size, and hence greater productive efficiency and competitiveness in markets where economies of scale are important.<sup>63</sup>

The World Bank describes as “deep integration” the way in which countries can realise the potential gains offered by scale and competition effects from PTA membership. It also notes that there is “considerable evidence” that PTAs have succeeded in attracting foreign direct investment (FDI) – pointing for example to a surge in FDI in Europe associated with the Single Market program, and a similar flow into Mexico linked to NAFTA membership. But this raises the question – parallel to the earlier discussion on trade flows – of whether PTAs are investment-creating or merely investment-diverting. It is notable, for example, that FDI in European Free Trade Association (EFTA) countries fell following the announcement of the EU's Single Market policy.<sup>64</sup>

Theoretical ambiguity has left economists divided on the merits of PTAs. 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. Global liberalization may be best, but regional liberalization is very likely to be good.”<sup>65</sup> He suggests that many PTAs will link countries that are already natural trading partners, and that as a result, the risk of significant trade diversion is relatively low in most cases. What's more, Summers also suggests that not all trade diversion needs to be treated as welfare-reducing; only where trade diversion replaces efficient with inefficient producers is there a problem.

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<sup>58</sup> One frequently cited example of trade diversion in practice is the impact of the EU's common agricultural policy (CAP) on agricultural trade.

<sup>59</sup> Meade (1955)

<sup>60</sup> Lipsey (1957). Lipsey's insight has been extended into the concept of “natural trading blocs” – the idea that countries that already trade extensively together will be predisposed towards forming PTAs. Some economists argue that natural trading blocs will not create significant trade diversion, and therefore be welfare-enhancing. But the generality of this result has been questioned by Bhagwati, Greenaway and Panagariya (1998)

<sup>61</sup> Summers (1991)

<sup>62</sup> Krueger (1999)

<sup>63</sup> Krugman (1991)

<sup>64</sup> World Bank (2000)

<sup>65</sup> Summers (1991)

Summers also discusses the issue of whether PTAs are good for the multilateral framework. In his view, PTAs could *accelerate* multilateral trade liberalisation, in part because a smaller number of trade blocs could find it easier to reach agreement than a large number of countries, and also because of the positive demonstration effect of successful agreements. In contrast, he says the argument that PTAs will slow multilateral liberalisation is “highly speculative at best”.

The view that PTAs are not necessarily damaging to the multilateral system has also been advanced by Ethier. He has suggested that while the Vinerian paradigm of trade creation and diversion was useful for understanding the “old regionalism” of the 1950s and 1960s, the change in the trading environment (the success of the GATT rounds and the move to unilateral trade liberalisation by emerging markets) calls for a new theoretical approach to understanding the new regionalism.<sup>66</sup> For Ethier, the new regionalism “is, in good part, a direct result of the success of multilateral liberalisation.”<sup>67</sup> For smaller economies – particularly emerging markets and transition economies – PTAs provide a commitment mechanism for locking in earlier, unilateral trade reforms.

Other frequently heard arguments in favour of the proposition that PTAs help promote global trade liberalisation include the proposition that they have a positive effect on multilateral negotiations by encouraging laggards to agree to liberalisation for fear of being frozen out of PTAs, and the claim that deeper integration also boosts demand for broader liberalisation. US trade negotiators, for example, have implied that the EU only agreed to participate in the Uruguay Round of multilateral trade liberalisation because of the impetus provided by NAFTA.

In marked contrast to this optimistic view of PTAs, eminent trade economist Jagdish Bhagwati has characterised the growth of such agreements as a “pox on the world trading system.” Bhagwati 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 the “good” ones (multilateral liberalisation).<sup>68</sup> Bhagwati refers back to Viner to emphasise that PTAs are *not* “free trade.” True, they remove tariffs for members but – for a given external tariff – they will increase the handicap facing non-members. What’s more, the “explosive proliferation” of PTAs produces a “messy maze” of agreements - a “spaghetti bowl” effect - that contributes to undermining the principle of non-discriminatory trade and complicates trade relations.

Bhagwati and fellow critics have also focused on the transactions costs created by the rules of origin required to make PTAs function. Rules of origin are needed in PTAs where members have different levels of external protection. Under these circumstances, there will be an incentive for imports to enter a PTA through the member country with the lowest level of protection, before being shipped on to the rest of the members. To avoid the resulting “trade deflection”, PTAs establish rules of origin which set out criteria for deciding whether a shipment coming from a member country can be deemed to have originated there (for example, there could be a requirement on the share of value-added created in a member economy). Such rules of origin can create significant costs, and be a source of substantial complexity. For example, the final NAFTA agreement contained over 200 pages dealing with rules of origin. A study by EFTA has estimated that the cost to EFTA members of rules of origin to get entry into the EU has amounted to around 3%-5% of the goods in question.<sup>69</sup> Similarly, the Asian Development Bank has noted that all PTAs in East Asia tend to have relatively complex rules of origin and that this “makes it profitable to alter production patterns simply to fulfil the rules for market access rather than to reduce costs and improve efficiency.”<sup>70</sup>

Panagariya has argued that not only do rules of origin have distortionary effects within a given PTA, but that they risk creating multiple distortions as the number of PTAs increases.<sup>71</sup>

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<sup>66</sup> Ethier (1998)

<sup>67</sup> The thinking here is as follows: empirically (and as noted in footnote 28) trade flows can be described by the gravity model of trade, which says the volume of trade will be positively related to GDP and negatively related to economic distance (comprising geographic distance and trade barriers). Multilateral liberalisation increases the importance of geographic distance relative to trade barriers as a constraint on trade, and hence will tend to make a given country’s trade more regional.

<sup>68</sup> Bhagwati (2002) Gresham’s Law states that bad money drives out good.

<sup>69</sup> Krueger (1999)

<sup>70</sup> Asian Development Bank (2002)

<sup>71</sup> Panagariya (1999)

Rules of origin could also have adverse consequences for international vertical specialisation by complicating firms' ability to source different stages of production in different countries.

Critics have also charged that PTAs divert scarce negotiating resources from multilateral trade negotiations. Other reasons advanced for PTAs being damaging to multilateralism include the possibility that firms that have benefited from the trade diversion effect of PTAs will be induced to lobby against wider liberalisation and the possibility that countries within PTAs could be more inclined to increase protectionist measures against non-members.

Finally, it needs to be recognised that many of the arguments made for PTA membership are political rather than economic in nature. Countries may seek membership in PTAs for security reasons, to improve their bargaining power, or to lock in domestic reforms. In its review of trading blocs, the World Bank concedes that often "regional integration is good politics", but worries that the resulting "sound bite economics" can be misleading when it comes to estimating the underlying economic costs and benefits of such agreements.<sup>72</sup>

### **PTAs in practice**

While economic theory does not provide a clear conclusion as to the merits of PTAs, neither does the empirical evidence. Thus a recent study by the OECD surveyed the body of empirical work undertaken on the effects of PTAs on trade and investment flows and economic welfare and concluded that "the empirical evidence has not so far produced more conclusive results than theory".<sup>73</sup>

The OECD study identified two broad categories of recent empirical work on PTAs. One group of studies (*ex post* studies) used econometric methods to test the impact of PTAs using historical data on the past experience of selected trade blocs. The second (*ex ante* studies) used computable general equilibrium (CGE) models to try to quantify the likely gains from future PTAs.

The majority of recent *ex post* studies use the gravity model of international trade.<sup>74</sup> A smaller set of studies estimates growth equations which include a proxy for PTA membership.

- The OECD found that most of the gravity model studies provided "fairly mixed results", with some PTAs apparently creating significant intra-bloc trade and others having little effect. The OECD also judged that the diversity of results makes it difficult to tell whether trade diversion was a significant problem.
- The growth studies reviewed by the OECD found that PTA membership had little impact on economic growth.
- Finally, the OECD's survey of CGE studies concluded that while they tended to find evidence of weak trade diversion, they also suggested that the recent wave of regionalism had been trade-creating on a net basis, and welfare-improving for member economies.

It is notable that *ex ante* studies tend to reach stronger conclusions than the *ex post* ones. For example, an *ex post* survey by Soloaga and Winters of nine PTAs over the period 1980-1996 finds little support for PTAs' leading to significant intra-bloc trade creation, and evidence of significant trade diversion is only found for two PTAs (the EU and EFTA).<sup>75</sup> In contrast, a survey of CGE modelling results by Robinson and Thierfelder finds that "trade creation greatly exceeds trade diversion in virtually all the [P]TAs studied."<sup>76</sup>

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<sup>72</sup> World Bank (2000)

<sup>73</sup> Organisation for Economic Co-operation and Development (2001)

<sup>74</sup> Standard gravity model variables are then 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 would then indicate trade creation; a negative variable for trade between a member and a non-member would indicate trade diversion.

<sup>75</sup> Soloaga and Winters (1999). A survey by Frankel of seven PTAs covering the period 1965-92 reaches similarly ambiguous conclusions. Frankel (1997)

<sup>76</sup> Robinson and Thierfelder (1999)

The OECD has also looked at the evidence supporting another claim for PTAs; that they promote “deeper integration” than is possible under the WTO. An OECD study compared rule-making provisions in PTAs with those in the WTO over ten areas: services, labour mobility, investment, competition policy, trade facilitation, government procurement, intellectual property rights, contingency protection, the environment and rules of origin. The OECD’s work confirmed that provisions in PTAs did tend to “go beyond” provisions in the WTO. But it also questioned whether such provisions were always “better” than those at a multilateral level, as opposed to just “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. The report’s conclusion was the nuanced observation that PTAs could complement but not substitute for multilateral rules/agreements.<sup>77</sup>

The difficulty with relying on broad empirical evidence is that whether a given PTA is welfare-increasing or reducing in practice may well depend on the specific characteristics and rules applying to that particular agreement. It seems likely that 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 any integration, and the nature of the rules of origin. Krueger, in concluding her survey on preferential trade agreements, notes for example that the Australia-New Zealand Closer Economic Relations Agreement (CER) appears to have provided an impetus for further trade liberalisation and at the same time done little to dent both economies’ push for continued progress with trade liberalisation at the multilateral level.<sup>78</sup>

### **PTAs and East Asia**

While PTAs are not new to the global economy, their recent spread to East Asia is a recent development. There has been a rush of proposals for new PTAs by economies in the region over the past few years, and crucially, these have included proposed agreements that would involve countries such as Japan and Korea - economies that have shifted from a long-standing policy of pursuing only multilaterally based trade liberalisation.<sup>79</sup>

Since until now the region has been committed to unilateral trade liberalisation and/or the multilateral route via GATT/WTO, this change is particularly significant for Australian policymakers.<sup>80</sup> True, an ongoing process of vertical integration and international specialisation had already brought rapid growth in intra-regional trade. But much of this has tended to occur against an expressed preference for what Garnaut has described as “open regionalism,” in that it has tended to be non-discriminatory in nature.<sup>81</sup> Now, however, the number of regional PTAs is multiplying, and the most significant of these - the proposed China-ASEAN free trade agreement (FTA) - would create the world’s largest FTA covering 1.7 billion people and a GDP of around US\$2 trillion.<sup>82</sup>

In part, growing regional interest in PTAs may just be a natural side-effect of the “deeper integration” associated with rising intra-regional trade in recent years. But several other factors also appear to be at work.<sup>83</sup>

For example, one important catalyst seems to have been the way in which the 1997-98 Asian financial crisis created a renewed awareness of the economic interdependence of the region. In particular, the experience of suffering from widespread financial market contagion has encouraged regional policymakers to contemplate increased integration at several levels as part of a strategy to manage the vulnerabilities created by greater market integration. At the same time, the steady rise of China as a regional and global economic power has led policymakers to judge that regional agreements provided a useful way of managing economic relations with their increasingly important neighbour. The World Bank, for example, noted in a recent report that the rise of China as a competitor in a range of

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<sup>77</sup> Organisation for Economic Co-operation and Development (2002)

<sup>78</sup> Krueger (1999)

<sup>79</sup> World Trade Organization (2001)

<sup>80</sup> The recent accessions of China (2001) and Taiwan (2002) to the WTO have been cited as evidence confirming a continued attachment to following the multilateral route.

<sup>81</sup> Garnaut (1994)

<sup>82</sup> Pangestu and Gooptu (2003)

<sup>83</sup> The following draws on Pangestu and Gooptu (2003), Harvie and Lee (2002) and Asian Development Bank (2002).

industries with the low- and middle-income countries in East Asia “strengthens the economic logic” for PTAs, since it means that trade creation is likely to exceed trade diversion, with production networks likely to “thrive” in an atmosphere of freer trade.<sup>84</sup>

The crisis also provided a political impetus to regionalism. In particular, Indonesia’s experience with the International Monetary Fund (IMF) led some policymakers in East Asia to draw the lesson that reliance on agencies external to the region involved a significant risk of conflicting economic and political agendas. Greater regional co-operation was seen as one way of reducing dependence on the IMF and hence the risk of having policies “dictated” by outside interests.

<b>Proposed and actual PTAs involving East Asian countries</b>			
	<b>Type of agreement</b>	<b>Status</b>	<b>Year</b>
<i><b>Bilateral Asia-Pacific</b></i>			
Singapore-Australia	FTA	Signed	2003
Singapore-Canada	FTA	Under Negotiation	2001
Singapore-Chile	FTA	Under Negotiation	2000
Singapore-Japan	New Age Economic Partnership	Signed	2002
Singapore-Mexico	FTA	Under Negotiation	1999
Singapore-New Zealand	Closer Economic Partnership	Implemented	2001
Singapore-Korea	FTA	Proposal	
Singapore-Taiwan	FTA	Proposal/Study	2002
Singapore-USA	FTA	Under Negotiation	2000
Korea-Australia	FTA	Official discussion	2000
Korea-China	FTA	Proposal/Study	
Korea-Chile	FTA	Under Negotiation	1998
Korea-Japan	FTA	Official discussions / Study	1998
Korea-Mexico	FTA	Official discussions / Study	2000
Korea-New Zealand	FTA	Official discussions / Study	2000
Korea-Thailand	FTA	Proposal/Study	2001
Korea-USA	FTA	Under Negotiation	2001
Japan-Canada	FTA	Proposal/Study	2002
Japan-Chile	FTA	Official discussions / Study	2000
Japan-Mexico	FTA	Official discussions / Study	1998
Japan-Thailand	Closer Economic Partnership	Proposal/Study	2002
Hong Kong-New Zealand	Closer Economic Partnership	Official discussion	2001
Thailand-Australia	Closer Economic Relations-FTA	Negotiations concluded	2003
Thailand-Croatia	FTA	Proposal	2001
Thailand-Czech Rep	FTA	Proposal	2001
USA-Australia	FTA	Official/Study/Negotiation	2002
USA-Philippines	FTA	Proposal	2002
USA-Taiwan			
China-Australia	Closer Economic Relations-FTA	Official discussions / Study	2003
<i><b>Regional plus</b></i>			
AFTA	FTA	Implemented	1992
AFTA+CER	Closer Economic Relations	Official discussions / Study	1999
ASEAN+China	FTA	Official/Study/Negotiation	2001
ASEAN+Japan	Comprehensive Economic Partnership	Official discussion	2002
ASEAN+Korea	FTA	Official discussion	2002
Singapore+EFTA	FTA	Signed, implemented	2003
ASEAN+3	FTA	Official discussions / Study	2000
ASEAN + India	FTA	Proposal	2003
<i><b>New regional</b></i>			
Japan-Korea-China	FTA	Official discussions / Study	2000
Pacific 5	FTA	Proposal	1998

Sources: Pangestu and Gooptu (2003) and media reports

A related political factor may be what Dalrymple has described as “an increasingly influential sense of share ‘Asianness’ in East Asia” which is being manifested in moves towards the “greater institutionalization” of relations between the region’s states, including through the formation of PTAs.<sup>85</sup>

<sup>84</sup> World Bank (2003)

<sup>85</sup> Dalrymple (2003)

It also seems likely that greater regional interest in PTAs is at least in part a defensive response to the proliferation of PTAs outside the region and the associated risk of trade and investment diversion. The continued eastward expansion of the EU, together with the possibility of an FTAA, has probably helped encourage the consideration of an equivalent regional bloc in Asia.<sup>86</sup> In addition, the relatively slow pace of trade liberalisation and reform under the auspices of the WTO may have produced some disillusion with the multilateral route, in particular following the failure at Seattle in 1999. The growing preoccupation of some industrial countries with the idea of fair trade – and the associated risk of new forms of protectionism – may also be a factor.

Several recent studies of East Asia's incentives for building PTAs have reached a broadly similar conclusion; that while PTAs are not a first best policy for the region, they could still bring positive benefits. Thus a survey by the Asian Development Bank concluded that PTAs in the region "appear to be a suboptimal route to free trade, but offer potential benefits."<sup>87</sup> Similarly, a World Bank report by Pangestu and Gooptu found that "broader liberalisation on a multilateral basis will lead to greater net benefits, but East Asia is likely to realize net gains if it pursues complementary regional approaches simultaneously with multilateralism."<sup>88</sup> Another World Bank report on regional initiatives in East Asia concluded that "[o]n balance . . . current trends suggest that countries will benefit from the pursuit of regional preferential trading agreements".<sup>89</sup>

### **The policy dilemma for Australia**

As a medium-sized open economy, Australia has a strong interest in the good health of the international trading system. Any benefits Australia would gain from an individual PTA would appear insignificant when set against the costs involved in a fragmenting global trading system. Since there is some (albeit hard to quantify) risk that the current shift towards PTAs could undermine the multilateral order, the new regionalism therefore represents an important challenge for Australian trade policy.

Despite being one of the 23 original signatories to the GATT in 1947, in many ways "Australia was not a willing convert to multilateralism". Rather, Canberra's initial instincts in the period following the Second World War were to prefer a strategy of relying on imperial preference and industrial protection.<sup>90</sup> But in subsequent years Australia has benefited from the multilateral framework created by the GATT and its successor. This has especially been the case since Australian trade policy underwent what 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 with participation in multilateral trade negotiations and regional and bilateral liberalisation on a MFN basis. This policy shift has subsequently been associated with rapid export growth and a marked improvement in relative economic performance.<sup>91</sup> Indeed, the average rate of growth of export volumes in the 1990s was the fastest of any post-war decade.<sup>92</sup>

The latest DFAT White Paper on foreign and trade policy considers the benefits offered by the multilateral and PTA approaches. It emphasises that the multilateral framework and negotiations in the WTO "remain Australia's best hope for better access for Australian goods and services to global markets". The White Paper also worries that the rise of PTAs presents "risks to Australian interests" by providing preferential access to export markets for competitors and threatening export diversion, and it warns that "inaction could risk an erosion of our competitive position". The proposed response to this changing environment is that "[w]hile the emphasis of the government will remain on multilateral trade liberalisation, the active pursuit of regional, and in particular, bilateral liberalisation will help set a high benchmark for the multilateral system."<sup>93</sup>

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<sup>86</sup> This motivation need not be purely defensive; the success of the EU and NAFTA could also have exerted a *positive* demonstration effect.

<sup>87</sup> Asian Development Bank (2002)

<sup>88</sup> Pangestu and Gooptu (2003)

<sup>89</sup> World Bank (2003)

<sup>90</sup> Capling (2001)

<sup>91</sup> Garnaut (2002a)

<sup>92</sup> Gruen and Stevens (2000)

<sup>93</sup> Department of Foreign Affairs and Trade (2003)

With PTAs supposed to set a “benchmark” for the multilateral system the government apparently intends that the agreements it enters into will (in the terms of the previous discussion) prove to be building blocks and not stumbling blocks for world trade. Either way, Australia is apparently succumbing to Baldwin’s “domino regionalism.”

Indeed, the government is already acting on the trade policy agenda it set out in the White Paper. A Singapore-Australia FTA became operational on 28 July this year, while the negotiations on an Australia-Thailand FTA were concluded in October. Negotiations on an Australia-US free trade agreement (AUSFTA) are currently underway, and the government has just announced that it will conduct a feasibility study with China into a possible future FTA.

<b>Australia's major trading partners 2001-02</b>									
<i>% of total</i>	Exports			Imports			Total trade		
	Total	Goods	Services	Total	Goods	Services	Total	Goods	Services
China	5.7	6.5	2.7	7.7	9.3	1.5	6.7	7.9	2.1
Germany	1.5	1.1	2.7	5.2	5.6	3.9	3.4	3.4	3.3
Hong Kong	3.6	3.3	4.6	2.2	1.2	6.1	2.9	2.2	5.4
Indonesia	2.7	2.7	3.0	3.1	3.4	2.0	2.9	3.0	2.5
Japan	17.3	18.9	10.9	11.3	12.9	5.4	14.3	15.9	8.1
Korea	7.0	8.2	2.5	3.4	4.0	0.9	5.2	6.1	1.7
Malaysia	2.2	2.1	2.6	3.1	3.2	2.5	2.6	2.7	2.5
NZ	6.5	6.4	6.9	4.2	3.9	5.0	5.3	5.1	6.0
Singapore	4.7	4.1	6.9	4.1	3.4	6.9	4.4	3.7	6.9
Taiwan	3.4	4.0	1.1	2.1	2.6	0.4	2.8	3.3	0.8
UK	5.7	4.3	11.0	5.9	5.2	8.6	5.8	4.7	9.8
US	11.1	10.0	15.1	18.4	18.0	20.1	14.8	14.0	17.6
<i>Memo items</i>									
Top 12	71.4	71.7	70.2	70.7	72.6	63.4	71.0	72.1	66.8
ASEAN	12.8	12.4	14.6	14.1	14.1	14.0	13.5	13.2	14.3
EU	13.7	12.3	19.3	20.8	20.7	21.2	17.3	16.5	20.3

Source: ABS

The above table shows Australia’s top 12 trading partners in 2001-02 as listed by the Australian Bureau of Statistics (ABS).<sup>94</sup> Australia has already concluded agreements with two of the 12 (New Zealand, Singapore) and is negotiating with a third (the US). China is now intended to follow, and the White Paper has also proposed negotiations with Japan and Korea.<sup>95</sup> There are significant obstacles to free trade agreements with these last three economies, however, including for example substantial Japanese and Korean agricultural protection.

<b>Investment stocks as of 30 June 2002</b>				
	Foreign investment in Australia		Australian investment overseas	
	<i>% of total investment</i>	<i>% of FDI</i>	<i>% of total investment</i>	<i>% of FDI</i>
Hong Kong	4.7	0.7	2.4	2.5
Japan	5.7	8.9	4.4	na
New Zealand	2.1	2.1	6.4	11.3
Singapore	3.8	5.5	2.6	0.8
UK	26.5	23.2	15.4	18.0
US	28.7	27.2	42.3	47.2
<i>Memo items:</i>				
Top 6	71.5	67.6	73.5	79.8+Japan
ASEAN	4.4	6.4	3.6	1.8
EU	34.9	39.2	2.8	21.8

Source: ABS

<sup>94</sup> The table shows how the precise ranking of countries as trading partners will vary depending on how the trading relationship is measured – as an export market for goods or goods and services, as an import source for goods or goods and services, or as total trade flows (exports plus imports).

<sup>95</sup> Australia and Japan signed a Trade and Economic Framework in July this year, but the Framework made no mention of a PTA.

## The debate over an Australia-US Free Trade Agreement

Canberra announced on 14 November 2002 that Australia and the US would begin negotiations on a free trade agreement (AUSFTA).<sup>96</sup> The resulting debate between supporters and opponents of an agreement highlights several of the issues covered in this paper.

Thus supporters of an AUSFTA claim that it offers an effective supplement to the relatively slow progress on trade liberalisation offered by following the WTO route, as well as a response to other regional trade initiatives such as ASEAN and the proposed ASEAN-China agreement. For example, DFAT has argued that an AUSFTA would “bring gains more quickly and more extensively than those available through the multilateral channels of the WTO.”<sup>97</sup> Supporters also point to empirical evidence that suggests that the agreement would on balance be trade-creating rather than trade-diverting. An AUSFTA is canvassed as a mechanism for promoting “deep integration” between the two economies, with the agreement covering investment and labour market regulations as well as trade in goods and services. And the political dimension is given an airing with proponents claiming that a FTA would help cement Australia’s political and security relations with the US.<sup>98</sup>

In contrast, opponents argue that the potential benefits from trade creation would be limited and would have to be set against the risk of significant trade diversion. In particular, they caution that since most of the potential gains of an AUSFTA would arise from difficult-to-negotiate areas such as agriculture and services, *realised* gains would tend to be smaller than *potential* gains. What’s more, they worry that AUSFTA would risk alienating Australia’s trading partners in the region – the likely victims of any trade diversion – as well as add to pressure on the multilateral trading system. For example, Garnaut notes that, according to the Centre for International Economics (CIE) study discussed below, Australian imports of motor vehicle components from Japan and Korea, and textiles, clothing and footwear from China, would be diverted to US suppliers.<sup>99</sup>

As might be expected from the previous discussion, the empirical evidence presented to date on the relative costs and benefits of an AUSFTA has not proved conclusive.

The most commonly cited study on the merits of an AUSFTA is by the Centre for International Economics (CIE).<sup>100</sup> This uses two macroeconomic models to gauge the costs and benefits. The Asia Pacific G-Cubed (APG-Cubed) model is used to capture dynamic and aggregate macroeconomic effects while the Global Trade Analysis Project (GTAP) model is used to capture detailed implications for specific commodities and regions. In common with most of the *ex ante* studies of PTAs noted above, the results find positive gains from an AUSFTA. Thus according to the APG-Cubed model results, membership in AUSFTA from 2001 could by 2010 have boosted GDP and real consumption in Australia by 0.4%, and in absolute terms real GDP could be nearly US\$2 billion higher. The GTAP model finds that the largest sectoral gains from an AUSFTA would accrue to the sugar and dairy industries, and that real GDP could be boosted by 0.34%.<sup>101</sup>

While the CIE report finds positive effects from an AUSFTA, modelling carried out by another group - ACIL Consulting - finds that an agreement “could be slightly detrimental to the Australian economy”. Thus ACIL estimates that an FTA agreement phased in over five years from 2005-2010 would produce a *fall* in real consumption of 0.5%. (In contrast, multilateral liberalisation enacted over the same period would produce a gain in real consumption of 0.17%).<sup>102</sup>

<sup>96</sup> For more detail on the government’s view of the negotiations see the section on the DFAT web site, <http://www.dfat.gov.au/trade/negotiations/us.html>

<sup>97</sup> Department of Foreign Affairs and Trade (2003)

<sup>98</sup> See for example Oxley (2003)

<sup>99</sup> See for example Garnaut (2002a)

<sup>100</sup> Berkelmans, Davis, McKibbin and Stoekel (2001)

<sup>101</sup> According to the modellers, GTAP reports a lower real GDP gain than APG-Cubed as the latter has a more sophisticated investment theory that results in a greater boost to capital formation.

<sup>102</sup> ACIL Consulting (2003). The CIE has pointed out that the different modelling results relate to the two studies’ different estimates regarding the import elasticity of substitution (and by implication its “dual”, the export demand elasticity). According to the CIE, the ACIL model uses a low elasticity – that is, it assumes that the degree of substitution between locally produced goods and imports is not particularly high. As a result, a fairly large price fall is required to induce increased demand for Australian exports. This in turn produces a decline in the terms of trade and a loss in welfare. In contrast, the CIE study uses trade elasticities that are about twice as large as those used in the ACIL report. If the estimates were “corrected” in this way, then the ACIL results would be similar to those produced by the CIE. Centre for International Economics (2003)

**Continued . . .**

The robustness of the CIE modelling results has been questioned.<sup>103</sup> For example, Garnaut points out that the assumptions used – provided by DFAT – unrealistically assume that all tariffs between the two economies are reduced to zero and that most quota restrictions are converted to tariff equivalents and again cut to zero. (In fact, the CIE study does look at intermediate cases - tariff cuts of 50% and 25% - but Garnaut notes that these still assume the cuts take place “across the board”, rather than make what he considers to be the more realistic assumption of no change for sensitive sectors like sugar in the US.) On the other hand, the assumption of no progress at all on these sensitive sectors may also be too pessimistic. Stoler, for example, notes that recent negotiations on a US-Chile FTA indicate that the US might be prepared to concede gradual liberalisation in some of these sensitive sectors.<sup>104</sup> Another criticism of the CIE results is that the model fails to take into account rules of origin and other transaction costs. Supporters of the deal counter that the econometric evidence fails to take fully into account the dynamic effects of trade liberalisation on economic growth and investment promotion.

Garnaut has also pointed out that the gains from the model are relatively small when set against the benefits Australia would gain from unilateral trade liberalisation, with the implication that political and strategic factors should be given more weight in the decision.<sup>105</sup> He highlights several such factors – including the risk that an AUSFTA could create perceptions that Australia was focusing outside the region, and that this would encourage other regional economies to push ahead with their own PTAs and so further undermine the multilateral system – that he feels provides a case for not following the AUSFTA route. The political arguments however are not clear-cut. For example, Wood has noted that the Asia-Pacific region is already going down the PTA route, suggesting that another such agreement “is not excessively newsworthy”. Similarly, fears that it will undermine Australia’s relations with other trading partners may be overdone. Wood notes, “implicitly there is no concern on China’s part that Australia may fail to take due account of the region. It has just signed up for a \$23 billion natural gas contract clearly knowing Australia’s thinking on a possible FTA with the US.”<sup>106</sup> China’s recent decision to agree to a study on a possible FTA with Australia would seem to further reinforce this verdict.

The stock of Australian inward and outward investment by country is also reported above. This shows that a smaller subset of countries dominates Australia’s international investment decisions than Australia’s trading relations. Again, two of the group (Singapore and New Zealand) are already covered by PTAs, while an FTA with the most important – the US – is under negotiation.

The rise of the New Regionalism and the spread of PTAs present Australian policymakers with an important policy dilemma. Should Australia continue to climb on board the PTA bandwagon? Or should it stand aside from the rush to bilateral and regional trade agreements and concentrate its attention on promoting and sustaining the multilateral system? The move to negotiate AUSFTA in particular has already triggered a heated debate that has accompanied the broader discussion about the merits of PTAs outlined in previous sections of this paper (see also the box below), with key Australian economists like Garnaut emphasising that a deal with the US “would be a major departure” from the recent direction of Australian trade policy.<sup>107</sup>

Critics of the government’s decision to negotiate PTAs focus on the risks posed to the international trading system by the proliferation of such agreements. They warn that by signing up to new bilateral and regional agreements, Australia not only adds momentum to the global PTA bandwagon, but also gives added legitimacy to the spread of preferential trade in East Asia. In their view, Australia would do better to stand aside from PTAs and concentrate its efforts on reinvigorating the WTO process.

Supporters of Australia’s involvement in PTAs would focus on the risks involved in remaining outside the trend to PTAs and argue that bilateral and regional arrangements can be complementary to multilateral trade liberalisation. The proposition here would be that the growth in PTAs will continue regardless of what Australian policymakers do, so policymakers should take the “New Regionalism” as an exogenous constraint on policy and act accordingly.

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<sup>103</sup> See for example Garnaut (2002a)

<sup>104</sup> Stoler (2003)

<sup>105</sup> Garnaut (2002b)

<sup>106</sup> Wood (2002)

<sup>107</sup> Garnaut (2002b)

Garnaut has characterised this type of argument as the “Theory of the Unimportant Country” and reckons that it is unduly pessimistic about Australia’s ability to influence the international trading system.<sup>108</sup> Certainly, ascribing to Australian policymakers no ability to influence international trade policy seems too pessimistic, especially given this country’s past successes in this area.<sup>109</sup> But at the same time the momentum behind the PTA bandwagon is strong enough that the ability of any single medium-sized economy to halt it looks questionable, especially since East Asia has now joined the global shift toward preferential trade.

The dilemma for Australian trade policy therefore is whether to continue to push ahead with additional PTAs and run the risk of inflicting collateral damage on the multilateral trading system, or to go no further down the preferential trade path and therefore risk being “left behind” in the event that the rush to PTAs continues and leaves the WTO and the multilateral trading system increasingly sidelined.

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<sup>108</sup> Garnaut (2003)

<sup>109</sup> Capling (2001)

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