



WORLD TRADE
ORGANIZATION

World Trade Report 2011

The WTO and preferential trade agreements:
From co-existence to coherence



What is the World Trade Report?

The World Trade Report is an annual publication that aims to deepen understanding about trends in trade, trade policy issues and the multilateral trading system.

Using this report

The 2011 World Trade Report is split into two main parts. The first is a brief summary of the trade situation in 2010. The second part focuses on the special theme of preferential trade agreements.

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Foreword by the WTO Director-General

This year's *World Trade Report* takes an in-depth fresh look at preferential trade. The choice of this topic reflects two significant trends in international trade relations, both of which carry far-reaching implications for the multilateral trading system. The first and most readily evident of these is the continuing growth and increasing prominence of preferential trade agreements (PTAs). In the last two decades, the number of PTAs has increased more than four-fold, to around 300 active agreements today. There is no reason to assume that PTAs will cease to grow in number or that they will not form part of the long-term tapestry of international trade relations. Secondly, the content of PTAs continues to evolve and deepen, reflecting important changes in the world economy. This too raises vital questions about the focus and reach of the WTO, and the value assigned by governments to globally-based trade relations.

The perennial concern about the relationship between the multilateral trading system and PTAs has provoked different reactions among commentators and analysts. Some would emphasize a clash of systems and inherent inconsistencies between discriminatory and non-discriminatory approaches to trade relations. Others would point to the growing prominence of PTAs as a reflection of the demise of multilateralism. Others still would assert that regional and multilateral arrangements are in essence complementary and need to be fashioned accordingly. None of these perspectives can singly capture the complexity of international trade relations in a globalizing world.

Our report seeks to navigate a way through these complexities in bringing new data and analyses to understand these issues. It acknowledges the multiple motivations for preferential approaches. At the same time, the report identifies important ways in which the focus of trade policy, particularly of the preferential variety, is being reshaped to reflect the consequences of past policies as well as changes in production structures internationally.

In earlier times PTAs were most likely to be motivated by the desire to avoid relatively high most-favoured nation (MFN) tariffs. The theory on free trade areas and customs unions mirrored this reality by placing the notions of trade creation and trade diversion centre-stage. At the same time, considerable attention has been paid to the discriminatory effects of rules of origin on the trade of third parties. More recently, this context has lost some of its relevance because underlying realities have changed. As the report documents, average tariffs have fallen markedly in recent years, making tariff preferences a more minor motivation for entering into PTAs. Furthermore, it seems that where MFN tariffs remain high they are also excluded from preferential reductions, additionally weakening this motivation.

As tariff preferences have diminished in importance, non-tariff measures have become relatively more significant as determinants of market access and the conditions of competition. Non-tariff measures come in many shapes. They may be designed to influence competitive conditions in markets, just like tariffs, or they may focus on public policy concerns such as health, safety, and the environment. These public policy interventions also have trade consequences and may be more or less discriminatory in their effects.



For the most part, it would seem that non-tariff measures of the public policy variety have remained focused on consumer welfare and not benefits to producers. However, the fact that interventions putatively designed to protect consumers may also favour producers can lead to concerns over hidden protection and unwarranted market segmentation. In a world where the WTO is having difficulty advancing an updated multilateral agenda, the risks of preference-based discrimination and market disintegration built around regulatory divergence should not be disregarded.

An important additional element in the equation, stemming from the emergence of supply chain production as a prominent mode of twenty-first-century integration, is that new regulatory matters are increasingly on PTA agendas. These include issues such as investment, competition policy, government procurement and harmonization or mutual recognition of product and process standards. The report analyses the content of a large number of PTAs in terms of whether they augment WTO provisions in particular policy areas and introduce entirely new issues. Both of these tendencies are identified in many PTAs, particularly those that have entered into force more recently. Here, then, is another reason why we need to remain attentive to policy fragmentation. To the extent that the desire for deeper integration under PTAs, in both WTO and non-WTO areas of regulation, is driven by the logic of vertically integrated international production structures, one is less likely to encounter discriminatory intent lurking behind regulatory cooperation in PTAs. But we should be mindful of the possibility that even in the absence of intent, market segmentation and discriminatory outcomes could be an unavoidable consequence of these arrangements.

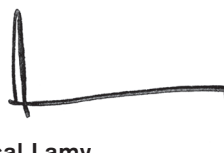
The report pays explicit attention to the question of what is needed in a multilateral context to ensure that

PTAs and the WTO do not simply run on parallel tracks, offering plentiful opportunities for inconsistency and conflict. This focus explains the subtitle of the report – “From co-existence to coherence”. What then, should the WTO be doing? It has often been said that if the WTO made progress in multilateral negotiations, both on market access and rules, this would soften the likelihood of clashes and inconsistencies with PTAs. This is undoubtedly a valid point, but the experience of the Doha Development Round during the last decade has raised questions about the ability and willingness of governments to advance the multilateral agenda. It has also raised the need to connect the multilateral and bilateral “brains” of trade policy drivers and actors. We need a better record if we are to attain greater coherence between the WTO and PTAs through successful multilateral negotiations.

A second possibility is to continue the quest for greater legal clarity and detail in the WTO rules about what is permissible under PTAs. Progress here could blunt the likelihood of damaging discriminatory outcomes under PTAs, whether intentional or otherwise. Here again, however, years of effort in the Doha Round and before to address multilateral provisions on PTAs have yielded limited results. It is for governments to determine whether they need greater legal certainty in this domain. If they do, perhaps a more circuitous route to the objective is precisely the one that members have recently embarked upon. The provisional establishment of the Transparency Mechanism for Regional Trade Agreements may pave the way for non-litigious deliberations that could build confidence and understanding among members regarding the motives, contents and policy approaches underpinning regional initiatives, leading over time to a shared vision and reinforced legal provisions.

Thirdly, to the extent that PTAs are motivated by a desire for deeper integration rather than market segmentation, there could be a role for the WTO to promote greater coherence among non-competing but divergent regulatory regimes that in practice cause geographical fragmentation or raise trade costs. This agenda has been referred to as multilateralizing regionalism. In some cases the multilateralization effect occurs *de facto* because regulatory reforms undertaken in a PTA context are applied in a non-discriminatory manner. This MFN dividend could be built upon in other policy areas. The feasibility of this approach would need to be researched further.

Whatever view one takes of precisely how to promote a global orientation in trade relations, there is no doubt that we need to build towards a more stable and healthier trading environment, where alternative trade policy approaches are mutually supportive and balance equitably the needs of all nations. It is to the discussion of this agenda that this year's *World Trade Report* seeks to make a contribution. I hope members will have a first opportunity to consider some of the issues in this report at the upcoming 8th WTO Ministerial Conference in December 2011.



Pascal Lamy
Director-General

Executive summary

Section A: Introduction

The report is divided into four main parts. The first provides an historical analysis of preferential trade agreements (PTAs) and a description of the current landscape. It documents the large increase in PTA activity in recent years, breaking this down by region, level of economic development, and type of integration agreement. It provides a precise estimate of how much trade in PTAs receives preferential treatment.

The second section discusses the causes and consequences of PTAs, focusing on both economic and political factors. A distinction is made between shallow and deep integration in order to suggest that traditional theories do not fully explain the emerging pattern of PTAs. The report examines in particular the role of international production networks in prompting the creation of deep PTAs.

The third section focuses on the policy content of PTAs, with particular reference to the depth and scope of commitments compared with those contained in the WTO agreements. It supports the link between production networks and PTAs with both statistical evidence and case studies.

The final section identifies areas of synergies and potential conflicts between PTAs and the multilateral trading system and examines ways in which the two “trade systems” can be made more coherent.

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Section B: Historical background and current trends

The formation of trading blocs: a historical perspective

Global trade relations have never been uniform or monolithic and regional trading arrangements have been around for centuries.

Regional trading arrangements have encompassed empires and colonial spheres of influence, bilateral commercial treaties and, more recently, multilateral agreements. They have often overlapped and interacted, creating a trade landscape defined less by clear-cut choices between regionalism and multilateralism – or discrimination and non-discrimination – than by the complex interplay, even competition, among multiple trade regimes.

Despite this complexity, in more recent times trade co-operation has become broader and more inclusive. Defining landmarks in this trend have been the establishment of the GATT in 1947 and the WTO in 1995. At the same time, trade relations have become deeper and more far-reaching, incorporating areas such as services trade, foreign investment, intellectual property and regulatory regimes. These tendencies are a clear reflection of the growing integration of the world economy and the “internationalization” of policies that were once considered domestic. In some cases, regional agreements have progressed further in this direction than the over-arching multilateral framework.

Progress has not been continuous, and there have been major set-backs and reversals along the way. The economic depression of the early 1870s, for instance, effectively brought the expansion of Europe’s bilateral trade treaties to an end, just as the “Great Depression” of the early 1930s helped fuel the spread of defensive and increasingly hostile trade blocs in the inter-war period. Conversely, the push for a more open and inclusive trading order has been strongest during periods of economic expansion and international peace. A main justification for creating the GATT in the post-war period was the widely held belief that hostile trade blocs had contributed directly to the economic chaos of the 1930s and the outbreak of the Second World War.

The establishment of the post-war multilateral trading system did not diminish the attraction of bilateral or regional approaches to trade arrangements and led instead to a period of creative interaction and sometimes tension between multilateralism and regionalism.

The first wave of regionalism in the late 1950s and 1960s was driven by Western Europe's push for continental integration, leading to the establishment of the European Economic Community (EEC) in 1957 and the European Free Trade Agreement (EFTA) in 1960. Throughout this period, GATT tariff cutting and membership enlargement moved in tandem, first with the Dillon Round in 1960-61 and then with the much more ambitious Kennedy Round between 1964 and 1967.

Subsequent waves of regionalism, from around the mid-1980s onwards, reflected an increasing embrace of such arrangements in the Americas, Asia and Africa, as well as in Europe. The continuing proliferation of regional agreements over the last 25 years involves a wide network of participants – including bilateral, plurilateral and cross-regional initiatives – and encompasses countries at different levels of economic development – including “developed-developed”, “developing-developing”, and “developed-developing” alliances. These newest agreements also often address WTO+ type issues, such as services, capital flows, standards, intellectual property, regulatory systems (many of which are non-discriminatory) and commitments on labour and environment issues.

The Uruguay Round (1986-1994) coincided with a period of growing regionalism and several issues, including services and intellectual property, were addressed for the first time both regionally and multilaterally. The continuing proliferation of PTAs in parallel with the Doha Round has provoked a debate about coherence, compatibility and potential conflict between multilateral and regional approaches to trade cooperation. Among the questions addressed in this debate are whether burgeoning regionalism signals a weakening of international commitment to open trade, and foreshadows a return to a more fragmented trading system. Alternatively, PTAs may be part of a broad pattern seen since the Second World War – where some countries want to move “further and faster” in trade rule-making than others, where bilateral and regional agreements can have a positive, “domino effect”, encouraging the pace of multilateral cooperation (and vice versa), and where regional and multilateral agreements are becoming coherent, not conflicting, approaches to managing a more complex and integrated world trading order.

Stylized facts about PTAs

PTA participation has accelerated over time and become more widespread.

From the 1950s onwards, the number of active PTAs increased more or less continuously to about 70 in 1990. Thereafter, PTA activity accelerated noticeably. The number of PTAs in force in 2010 was close to 300. The surge in PTA activity is driven both by a growing number of countries taking an interest in

reciprocal trade opening and by an increase in the number of PTAs per country. All WTO members (with the exception of Mongolia) belong to at least one PTA.

PTA activity has transcended regional boundaries.

One half of the PTAs currently in force are not strictly “regional”. The advent of cross-regional PTAs has been particularly pronounced in the last decade. The trend towards a broader geographical scope of PTAs is even more pronounced for those PTAs that are currently under negotiation or have recently been signed (but are not yet in force). Practically all of these are of the cross-regional type.

PTAs have seen opposing trends towards further rationalization on the one hand and a sprawling web of new bilateral and overlapping deals on the other.

Numerous bilateral agreements have been consolidated into plurilateral agreements either via accessions or negotiations between existing PTAs. Examples include successive EU enlargements, the consolidation of bilateral pacts between Eastern European countries in the context of the Central European Free Trade Agreement (CEFTA) and the conclusion of a PTA between Mercosur and the Andean Community in the Latin American Integration Association (LAIA) framework.

At the same time, a parallel trend is discernible towards bilateral deals across regions. While many of these bilateral arrangements are between developing countries, developed countries have also played a part. A consequence of this trend is an increased fragmentation of trade relations, with countries belonging to multiple, sometimes overlapping PTAs.

Free trade agreements are far more prevalent than customs unions and a number of products continue to be excluded from preferential access.

Free trade agreements account for more than three-quarters of all PTAs in force. Although GATT Article XXIV requires that import duties are to be eliminated on substantially all trade among the members of customs unions and free trade areas, some products are often excluded. A recent study of PTAs involving four major trading countries and their partners shows that about 7 per cent of tariff lines in the sample are excluded, either temporarily or permanently. These products are mainly agricultural or food items, and labour-intensive manufactured products such as footwear and textiles.

The coverage of PTAs in terms of policy areas has widened and deepened over time.

Notwithstanding the prevailing pattern of specific product exclusions from tariff elimination, most recent

PTAs go beyond traditional tariff-cutting exercises and may include such policy areas as services trade, investment, intellectual property, technical barriers to trade and dispute settlement. For instance, about one-third of PTAs in force today contain services commitments compared to less than a tenth in 1990.

Stylized facts about trade flows related to PTAs

The value of world trade between members of preferential trade agreements has increased as the number of PTAs has expanded.

Intra-PTA trade represented about 35 per cent of total world merchandise trade in 2008, compared with 18 per cent in 1990.¹ Preferential trade – that is, trade actually receiving preferential tariff treatment – represents a much smaller share of world trade. However, it is still worth considering total trade among PTA members because the latest generation of trade agreements may be motivated by a broader set of considerations than just tariff reductions, including the development and maintenance of supply chains.

The share of manufactured goods in total intra-PTA exports is the same as the share of manufactured goods in world trade (65 per cent), and this share does not vary much across PTAs. However, intra-PTA trade in parts and components does vary significantly across trade agreements, suggesting a link between some PTAs and vertically integrated production structures.

Plurilateral trade agreements accounted for half of global intra-PTA trade in 2008, while bilateral trade agreements (including those where one party is a PTA) accounted for the other half.

If many recent PTAs were designed to support production networks, we might expect to see greater geographic concentration of trade over time, since many production networks are regional in nature. Evidence of this exists only for certain regions.

The share of intra-regional trade in Europe's total exports remained roughly constant at around 73 per cent from 1990 to 2009. Asia's intra-regional trade share increased from 42 per cent to 52 per cent of total exports during the same period. North America's intra-regional trade share rose from 41 per cent in 1990 to 56 per cent in 2000, but then fell back to 48 per cent in 2009, so there appears to be no global pattern that applies to all industrialized regions. Developing regions that predominantly export natural resources have seen the share of intra-regional trade in their total exports shares rise substantially over the past 20 years or so, but they remain quite small.

The extent to which trade has become more geographically concentrated differs depending on the

type of goods being traded. The share of intra-regional trade in world exports of manufactured goods was quite stable between 1990 and 2009, fluctuating between 56 and 59 per cent, but the share for office and telecom equipment jumped from 41 per cent to 58 per cent. Taken together, these results suggest that supply chains may be an important component of recent PTA activity in Asia and in the electronics sector, but not so much in other regions or economic sectors.

How preferential is trade?

Trade among PTA members is not all preferential on account of the fact that a significant portion of intra-PTA trade is MFN duty-free.

In a sample covering imports of the 20 largest importers from all their trading partner countries – accounting for 90 per cent of world merchandise trade in 2008 – only 16 per cent qualified as preferential trade, assuming full utilization of preferences.² In other words, despite the explosion of PTAs in recent years, 84 per cent of world merchandise trade still takes place on a non-discriminatory most-favoured nation (MFN) basis. This is firstly because half of world trade is already subject to zero MFN tariff rates. Secondly, PTAs tend to exempt high MFN-tariff items from preferential treatment and continue to trade these products at MFN rates.

Existing preferential tariffs reduce the global trade-weighted average tariff by one percentage point, and 90 per cent of this reduction (i.e. 0.9 percentage points) is due to reciprocal preference regimes. Only 2 per cent of global imports are eligible for preferential tariffs where preference margins are 10 per cent or more. For most large exporters, preferential tariffs matter little for the bulk of their exports. This is not always true for individual sectors especially in certain smaller economies exporting a narrow set of commodities (mainly sugar, rice, bananas, fish and garments), where preference margins may be more substantial. There is a possibility though that these preferences will be eroded over time as the countries to which they export enter into more PTAs.

Data from some customs administrations suggest a high rate of preference utilization.

Information on the value of imports under different preferential regimes from the EU and US reveal preference utilization rates of 87 and 92 per cent respectively. Preference utilization rates are uniformly high for most exporting countries, preferential regimes and types of products. Analysis shows that both preference margins and import values have a positive and statistically significant impact on preference utilization. Surprisingly, however, many individual items facing tariffs below 1 per cent still exhibit high utilization rates. This might suggest either that the

cost of using preferential tariffs in certain cases is negligible or that other benefits are linked to using these preferences, perhaps related to privileged customs clearance, qualification under specific security measures or advantages in case of re-export to other PTA partners.

Data from firm surveys offer a more detailed and mixed picture of preference utilization rates.

Firm surveys carried out in 2007-08 by the Asian Development Bank (ADB) and the Inter-American Development Bank (IDB) in six East Asian countries and four Latin American countries respectively reveal that the use of PTA preferential tariffs is not uniformly high. For instance, the ADB survey shows that only around one-quarter of firms in the sample currently used these preferences. However, this number doubled when plans for using PTA preferences in the future were factored in. The IDB survey shows that only 20 per cent of the firms in the sample did not make any use of PTA preferences.

Complications and costs involved in complying with rules of origin were cited as considerations influencing preference utilization, especially where preference margins were low. The surveys also cited other firm-specific factors that influenced preference utilization. For instance, larger, more experienced firms, with higher foreign equity and more information about PTA provisions, were more likely to use preferential tariffs. Firms in a number of countries suggested that a lack of information on PTAs was the major explanation for the non-use of these preferences.

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Section C: Causes and effects of PTAs: is it all about preferences?

Motives for PTAs

Economic and political science theories provide various explanations for why countries establish preferential trade agreements.

Unilateral trade policy choices can have “beggar-thy-neighbour” consequences, such as unfavourably affecting the ratio of import to export prices (terms-of-trade effect) or a production relocation effect. Countries might be stuck in a situation characterized by high restrictions and inefficiently low levels of trade. A trade agreement could neutralize these beggar-thy-neighbour effects and achieve higher welfare. Economic theory suggests, however, that a multilateral agreement rather than a PTA is the best way to address the problem.

Gains in credibility suggest a second reason for signing a PTA. A government may choose to “tie its hands” through an international agreement in order to prevent future policy reversals that would be convenient in the short-run, but inefficient in the long term. A PTA may provide a stronger commitment than a multilateral agreement when a country is small in world markets.

“Non-traditional” reasons for why countries form PTAs include accessing a larger market, ensuring against preference erosion, increasing predictability of future trade policy, signalling stability to investors, and achieving deeper policy commitments.

The creation of PTAs cannot be understood without taking account of political circumstances. Political science explanations of PTA formation focus on the role of political integration, the role of domestic political considerations, the form of governments and institutions, diplomacy, and the role of power relations.

Changes in trade relationships may explain the growth of PTAs over time. Together with certain country characteristics, they may also explain the timing of PTA formation and enlargement.

The potential loss of market share for non-members of an existing PTA induces them to form new PTAs or join existing ones. These domino effects of PTA formation can be further strengthened with multilateral trade opening.

Among the factors accounting for the pattern of PTA formation and enlargement over time are the physical distance between countries, economic size, similarity in economic size, proximity of a potential entrant to an existing PTA, the extent of existing agreements facing a country pair, and the existing number of members in a PTA.

The standard economics of PTAs

The standard theory on the effects of PTAs suggests that preferential trade agreements increase trade between member countries and reduce trade with third-countries, leading to negative welfare effects for non-members of PTAs.

A PTA increases trade among members as exporters benefit from the elimination of tariffs in partner markets. Non-member countries suffer from a reduction of exports to member countries and a decline in the price of their exports in international markets.

In the traditional Vinerian analysis, preferential trade opening allows some domestic production to be replaced by imports from more efficient firms located in preference-receiving countries, leading to welfare gains (trade creation). At the same time PTAs may reduce imports from more efficient non-member countries, implying a welfare loss (trade diversion). The net welfare effect of PTAs depends on the relative magnitude of these opposing effects.

Supply chain or vertical production arrangements may change the welfare calculus.

The possibility of trading components used in the production of final goods alters the calculation of trade creation and trade diversion. Although the outcome is still uncertain, welfare-reducing PTAs trading only in final goods could become welfare-improving once members trade in parts and components along a supply chain. In this way, international production networks can mitigate the trade diversion effects of PTAs, although this is by no means guaranteed.

The trade effects of a preferential agreement depend on the economic characteristics of PTA members.

The “natural trading partners” hypothesis suggests that trade agreements among countries which trade intensively are more likely to be trade-creating. Preferential trade agreements may also have dynamic effects, for instance driven by economies of scale, and effects on the location of production.

Several studies have tested the traditional theories on trade creation and trade diversion. While this literature is not conclusive, it suggests that trade diversion may play a role in some agreements and in some sectors, but it does not emerge as a key effect of preferential agreements.

When governments have political economy reasons for signing a PTA, the question arises whether trade-diverting or trade-creating agreements are more politically viable and

whether a PTA reduces or increases the incentive to set inefficiently high external tariffs.

In shaping their PTAs, governments may not be influenced exclusively by the welfare implications of agreements. If organized lobby groups carry sufficient weight in the political preferences of governments, trade-diverting PTAs could be politically viable in some circumstances.

Moreover, conflicting political economy forces may act upon external tariffs agreed in a PTA. On the one hand, PTAs destroy protectionist benefits and lower the demand for high external tariffs. On the other hand, high external tariffs can be used in PTAs to sustain cooperation on non-trade issues. The empirical literature finds evidence of both effects.

Restrictive rules of origin (RoOs) in PTAs may divert or suppress trade in intermediate goods.

Restrictive RoOs may make it profitable for firms in a country to engage in “supply switching” – replacing an efficient non-member supplier of an intermediate good with a less efficient one, either from a partner country (trade diversion) or a domestic firm (trade contraction or suppression). Furthermore, by influencing the sourcing of intermediate goods, RoOs are likely to increase firms' costs and hence have an adverse effect on final goods trade.

This discrimination, which leads to trade diversion by protecting the exports of certain industries in PTA member countries, can be resolved through the “diagonal cumulation” of RoOs. Under this arrangement, participating countries agree that in all PTAs concluded among themselves, materials originating in one country can be considered to be materials originating in any of the other countries.

Going beyond the standard analysis

The concept of deep integration is widely used to refer to any arrangement that goes beyond a simple free trade area.

Trade agreements that mostly deal with border measures are often defined as “shallow” agreements. In contrast, preferential agreements that include rules on other domestic policies are referred to as “deep” agreements.

Two distinct dimensions of deep integration are the “extensive” and the “intensive” margin. The extensive margin refers to an increase in the policy areas covered by an agreement, while the intensive margin refers to the institutional depth of the agreement. The extensive and intensive dimensions of deep agreements may be related, as an extension of the coverage of an agreement may require the creation of common institutions for its proper functioning.

Deep integration and trade are intimately related.

Deep arrangements may be necessary to promote trade in certain sectors and economic integration more broadly. For instance, harmonization or mutual recognition of certain regulations may be a prerequisite for trade in services, or competition policy rules may be required to allow comparative advantage to materialize.

Economic theory also suggests that the degree of trade openness is a determinant of deep agreements. In this respect, shallow and deep integration may be seen as complementary where the first generates a demand for governance that the second can provide.

An institutional challenge for the WTO is to find an approach that facilitates deeper integration sought by its members while maintaining compatibility with the non-discrimination principle.

The rise in international production networks illustrates the complementarity between trade and governance which is at the core of successful deep agreements.

In order for cross-border production networks to operate smoothly, certain national policies need to be harmonized or rendered mutually compatible to facilitate business activities in several countries. This generates a demand for deep forms of integration.

Developed countries were the first movers in the attempt to provide some international rules to further encourage international fragmentation of production. Agreements such as the EU Single Market Programme or the US-Canada free trade area can be explained (at least in part) in terms of increased demand for deep integration generated by the needs of international production sharing arrangements.

The continuous expansion of production sharing between developed and developing countries requires deeper agreements to fill the governance gap between countries. An agreement such as the North American Free Trade Agreement, for example, includes disciplines going beyond preferential tariffs that are required to facilitate production sharing between the United States and Mexico. In Europe the Euro-Mediterranean agreements fulfil the same objective.

The recent wave of preferential agreements may (at least in part) be an institutional response to new circumstances created by the growth in offshoring. In this sense, PTAs are efficiency-enhancing rather than beggar-thy-neighbour (trade-diverting) agreements.

Deep integration may involve several trade-offs that need to be addressed.

A basic trade-off arises between the benefits of common policies and the costs of harmonization when policy preferences differ among member countries.

Deep integration lowers trade costs and provides shared benefits, such as common rules and a stable monetary system, that the market or national governments fail to offer. However, no unifying analysis is possible of the economic effects of deep integration, as these effects depend on the specific form that arrangements take.

Deep integration with advanced economies may create advantages for developing countries from importing best-practice institutions. However, costs may be involved if the common rules are distant from national preferences and the needs of developing countries.

Deep integration also has systemic effects. Deep agreements may impose costs on non-member countries. On the other hand, deep regional integration could provide an appropriate intermediate level of integration (e.g. common rules) between nation states and the global level in different behind-the-border areas.

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Section D: Anatomy of preferential trade agreements

Preferential tariffs and PTAs

Preference margins are small and market access is unlikely in many cases to be an important reason for creating new PTAs.

The estimated average applied tariff across all products and countries was 4 per cent in 2009, and the scope for exchanging preferential market access is therefore limited. Significant tariff barriers still exist in some sectors, however, such as agriculture and labour-intensive manufactured goods. However, PTAs do not appear to be about the removal of tariff peaks either. Most sensitive sectors remain sensitive (subject to higher tariffs) in PTAs. Approximately 66 per cent of tariff lines with MFN rates above 15 percentage points have not been reduced in PTAs.

When the advantage conferred by providing preferential access to an exporter is calculated with respect to the average applied tariff faced by all exporters to the same market rather than relative to the MFN rate, the share of global trade for which preferential market access matters is less than 13 per cent.

Patterns in the content of PTAs

PTAs cover many more policy areas than tariffs and frequently entail legally enforceable commitments.

In a sample of almost 100 PTAs, deep integration elements were classified into WTO+ areas and WTO-X areas. WTO+ refers to deeper integration in areas covered by the WTO and WTO-X refers to policy areas not covered in WTO agreements. The analysis confirms that many PTAs go beyond the WTO and these deep integration provisions are frequently enforceable legally.

As expected, WTO+ provisions universally include industrial and agricultural tariffs. An increasingly large number of PTAs now also include provisions on technical barriers to trade, services, intellectual property and trade-related investment measures. WTO-X provisions commonly include competition policy, investment and the movement of capital. About one-third of the PTAs in the sample also include environmental laws, labour market regulations and measures on visa and asylum.

Compared with PTAs between trading partners with similar levels of income, those between developed and developing countries contain a higher number of WTO+ provisions on average. WTO-X provisions are encountered most frequently in agreements between developed countries, followed by those between developed and developing countries, and finally those between developing countries.

Overall, services commitments in PTAs have gone well beyond commitments in the General Agreement on Trade in Services (GATS) as well as Doha Round offers in services.

Services obligations typically form part of comprehensive PTAs covering “new generation” issues such as investment, intellectual property, or e-commerce. Out of 85 notifications under Article V of the GATS,³ a little more than a third rely on a GATS-type listing of areas where specific commitments apply (positive list), almost half rely on the more comprehensive approach of indicating where specific commitments do not apply (negative list) and the remainder adopt a mixture of the two approaches.

Despite innovations in their structure, most services PTAs share a broad commonality with the GATS in terms of the basic set of disciplines, although some PTAs have gone beyond GATS with respect to disciplines on domestic regulation or transparency, for example.

The investment chapters in PTAs contain many provisions and guarantees that are important to international production networks.

Since firm-specific assets such as human capital (management or technical experts) and intellectual property (patents, blueprints) give international firms a competitive edge, protecting these assets against expropriation will encourage more production sharing. Allowing freer movement of corporate personnel is another critical requirement. Investor confidence will be further improved through access to a dispute settlement mechanism.

From the sample of investment chapters in PTAs used for this report, it appears that a large proportion of agreements have adopted a negative list and hence a more ambitious approach to investment opening. They typically extend MFN and national treatment to foreign investors, provide guarantees of investor protection and grant private investors the right to dispute settlement. In general, the investment provisions in these PTAs are accommodating, although no attempt has been made to test how much these provisions actually affect flows of foreign direct investment. More recent PTAs appear more open on the investment front than earlier ones.

As tariff barriers have progressively been reduced, non-tariff barriers have acquired increasing weight. Over time, more and more PTAs have included provisions regarding technical barriers to trade (TBTs).

The inclusion of specific provisions in PTAs appears to follow a hub and spoke structure, with a larger partner representing the hub to whose standards the spokes will conform. For example, while the agreements

signed by the EU typically include harmonization provisions, North American agreements that embody TBT provisions tend to prefer mutual recognition. In addition, North American, East Asian and South-Central American TBT provisions in PTAs mainly focus on introducing transparency requirements and developing institutional bodies, while EU and African agreements barely consider these issues.

The risk of a lock-in effect exists in regional provisions on TBTs.

Harmonization to a regional standard may increase the costs for further multilateral liberalization. If adopting a certain standard involves the payment of some form of fixed costs, the risk exists that regional provisions may work as a stumbling block in multilateral cooperation.

Competition policy complements the reduction of trade barriers.

The adoption of competition policy in PTAs is in many ways a natural complement to the reduction of trade, investment and services barriers. In evaluating competition rules in PTAs, one needs to go beyond the competition policy chapter of PTAs to include competition-related provisions that appear in other chapters of trade agreements. Competition disciplines appear in the chapters on investment, services (in telecommunications, maritime transport and financial services), government procurement and intellectual property.

Sector-specific competition provisions may have stronger pro-competitive effects than the articles in the competition policy chapter itself, assuming that the trade agreement has one. Principles in PTAs relating to non-discrimination, procedural fairness and transparency can also have a strong bearing on competition law and policy.

Many elements of competition rules in PTAs are characterized by non-discrimination.

Competition disciplines usually operate through the use of domestic regulations. While it is not impossible for these regulations to be tailored to favour enterprises originating from PTA partners, it may be costly to do so. To the extent that enforcement of competition law reduces the market power of domestic incumbents, the prospects of foreign enterprises that already operate in the market are improved, whether or not they are from a PTA member.

Competition provisions in regional agreements may carry other external benefits, such as economies of scale from the creation of a regional competition authority. Even if no centralized authority is established, benefits can flow from information sharing and cooperation among enforcement authorities. Demonstration effects may also apply when a

competition authority in one PTA member takes action against anti-competitive behaviour.

Production networks and deep PTAs

Empirical analysis confirms the positive association between deep integration and production networks.

Lack of data poses some difficulties in assessing the international fragmentation of production, forcing empirical studies to rely on proxy measures for production networks. This analysis uses trade in parts and components to proxy for global production sharing.

Results show that greater trade in parts and components increases the depth of newly signed agreements among PTA members. PTAs also increase trade in parts and components by 35 per cent among members. In addition, the greater the depth of an agreement, the bigger the increase in trade in parts and components among member countries. The estimation results show that on average, signing deep agreements increases trade in production networks between member countries by almost 8 percentage points.

The case of ASEAN: from regionalization to regionalism.

ASEAN was established in 1967 largely to deal with rising territorial tensions among some of its members (the original signatories were Indonesia, Malaysia, Philippines, Singapore and Thailand) and with possible spillovers from the conflict in Indochina. In the quarter of a century that spanned the creation of the association and the decision formally to establish the ASEAN free trade area (AFTA), there was a shift in economic policy from traditional import substitution to export promotion and openness to foreign direct investment.

This led to a huge increase in total merchandise exports of the five original members. In particular, exports of parts and components became increasingly important, rising from just about 2 per cent of total exports in the year of the association's founding to 17 per cent by the time the free trade agreement was signed. Equally telling was the increased prominence of parts and components trade in intra-regional trade.

While the increased regionalization of trade in parts and components trade in ASEAN would not have been possible without the countries' openness to trade and foreign investment, it may not have been sufficient for production networks to continue to flourish. This may explain AFTA's evolution beyond a free trade area. Services and intellectual property agreements were signed in 1995, an investment agreement and dispute settlement mechanism in 1996, and a framework agreement for mutual recognition arrangements in

1998. Recent studies document how AFTA succeeded in reducing trade costs, not through preferential tariff liberalization but through concerted trade facilitation initiatives, and how this was motivated by participation in international production networks.

Production networks may explain some PTAs in Latin America too: the case of Costa Rica.

As a result of its policies of trade and investment opening, Costa Rica has experienced a significant change in its trade structure, with a substantial rise in the share of manufacturing exports as well as trade in services in total exports. Over the last decade, the country has become more integrated with global production networks in such sectors as electronics, medical devices, automotive, aeronautic/aerospace, and film/broadcasting devices.

The link between production networks and PTAs seems apparent in Costa Rica's agreements with the United States (US-CAFTA-DR agreement) and with China. While overall trade with the United States grew by about 11 per cent annually from 1995, parts and components trade grew at about twice that rate. More than 25 per cent of Costa Rica's total goods exports in 2009 were directly related to production networks in electronics, with China being the main trading partner. Overall, trade in parts and components makes up about half of Costa Rica's current trade with China.

Not all integration experiences conform to this pattern: the case of Africa.

The roots of African integration lay in the effort to correct the geographical fragmentation bequeathed by colonialism. Fragmentation resulted in small markets, land-locked economies, and limited development options. In the 1980s, the Lagos Plan of Action proposed the division of the continent into regional integration areas that would eventually constitute a united African economy.

For the most part, African integration has focused on import tariffs. The inclusion of services and other behind-the-border issues, such as investment, competition policy and government procurement, has proved contentious. A major limitation to African integration progress has been its adherence to a "linear" integration model. This process is marked by the stepwise integration of goods, labour and capital markets, and eventually monetary and fiscal integration.

Deep integration could improve Africa's record on regional cooperation.

Border measures are likely to represent a minor constraint to regional trade in Africa compared with structural economic shortcomings, such as a lack of infrastructure, an institutional framework, skills, and

economic diversification. Enhanced market access without the capacity to produce goods and services to benefit from those opportunities will fail to produce higher economic growth. At a regional level these supply-side constraints could be addressed in part by a regional integration agenda that includes services, investment, competition policy and other behind-the-border issues. In short, a deep integration agenda could address supply-side constraints more effectively than an agenda that focuses almost exclusively on border measures.

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Section E: The multilateral trading system and PTAs

Systemic effects of preferential tariff liberalization

A number of different mechanisms have been identified through which PTAs could foster or hinder multilateral trade opening.

The prospect of preference erosion can be a force for supporting further multilateral tariff reduction or for resisting it. The presence of political-economy motivations behind tariff reductions is another factor that can either foster or slow down the diminution of preferential tariffs through trade-opening on an MFN basis.

Opposition to further multilateral tariff reductions might also arise in the case of PTAs that are concluded to foster mutual cooperation on non-trade issues, or when PTAs increase the adjustment costs associated with multilateral opening, or when the PTA is trade-creating from the perspective of excluded countries.

Evidence on the systemic effects of regionalism on multilateral tariff reductions is inconclusive.

The literature that considers whether MFN and preferential tariffs complement or compete with each other finds opposite results for developing and developed countries. Most of the contributions to this literature, however, do not distinguish between MFN tariffs that have been negotiated at the multilateral level and unilateral tariff reductions.

Examination of the correlation between PTA formation and multilateralism cannot produce conclusive results because multilateral trade rounds are rare events, where more or less ambitious trade opening scenarios are negotiated. Multilateral trade negotiations are not structured to contemplate either full or zero trade opening. Anecdotal evidence can be found to support the view that PTAs facilitate further multilateral trade opening and the opposite view that they hinder it.

Deep PTA provisions and the multilateral trading system

So far not much research has been conducted on the systemic effects of deep-integration provisions. The existing literature suggests that deep integration is often non-discriminatory.

By their very nature, some deep integration provisions are *de facto* extended to non-members because they are embedded in broader regulatory frameworks that apply to all trading partners. In such cases, multilateral regulation may not be necessary. PTAs may also

directly refer to WTO rules on deep integration measures, automatically supporting the multilateral trading system.

Several mechanisms supporting further trade opening are found in PTAs. These include “non-party” MFN clauses, a tendency to use template approaches that replicate trade rules, and domino effects pointing in the direction of the progressive extension of preferential market access.

Production chains can alter political-economy forces in favour of the adoption of trade measures that comply with the principle of non-discrimination.

Final good producers sourcing their imports through international value chains are likely to support the harmonization of rules of origin across PTAs, for instance through the adoption of rules of cumulation.

The international fragmentation of production may also be a driver of deep integration provisions that are consistent with the principles of the multilateral trading system, such as international standards and multilateral rules on trade remedies.

Some deep provisions in PTAs can, however, contain discriminatory aspects, creating a tension with the multilateral trading system.

The risk of trade diversion may extend beyond tariffs, for example to the area of anti-dumping. Anti-dumping provisions in PTAs may result in members being spared from anti-dumping actions and an increased frequency of anti-dumping actions against non-members. Moreover, many PTAs exclude the imports of PTA partners from global safeguard actions.

Lock-in effects of regulatory harmonization within a given PTA may have negative systemic effects.

Competing PTAs with incompatible regulatory structures and standards may lock in members to a particular regime, undermining the principles of transparency and predictability of regulatory regimes and making movement towards multilateral trade opening costly.

The non-discriminatory nature of deep provisions might in principle create political-economy and third-country resistance to further multilateral opening.

If preferential liberalization is non-discriminatory in nature, it might be opposed by political-economy forces because higher market shares (and profits) in the other member's market might be more than offset by the loss of domestic profits *vis-à-vis* firms from partners and non-members.

Concerns over overlapping jurisdiction between the WTO dispute settlement system and the dispute settlement mechanisms of PTAs have received considerable attention in the academic literature.

The possibility that dispute settlement procedures in more than one forum can give rise to conflicting judgements has been discussed as a potential source of concern. The issue has been raised only in a handful of WTO disputes. A review of the disputes brought to the WTO reveals that members continue to use the WTO dispute settlement system to resolve disagreements with their PTA partners.

Seeking coherence between PTAs and the WTO

GATT/WTO provisions provide exemptions under certain circumstances from the MFN principle for PTAs.

Surveys of the application of these provisions suggest a relatively tolerant attitude towards PTAs. The provisions themselves are widely regarded as incomplete and lacking in clarity. Recently, attention has focused on improving transparency and the Doha Round negotiations have resulted in the introduction on a provisional basis of a new transparency mechanism.

The fact that the Transparency Mechanism for Regional Trade Agreements is the only result of the Doha negotiations that has been allowed so far to go forward independently of the full results of the Round suggests that WTO members are aware of the need to better understand what regional trade agreements are about.

The quest for coherence between regionalism and multilateralism is nothing new.

Until recently, ensuring coherence was broadly understood as accepting that PTAs and the multilateral system could complement each other while imposing disciplines aimed at minimizing the negative effects that PTAs could have. Approaches to improving coherence focused on the weaknesses of multilateral disciplines and how they could be fixed.

Recent developments in PTA activity may well change the perspective on coherence. Beyond the fact that PTA activity has accelerated noticeably since 1990, what may challenge the current thinking is that the new PTAs, or at least some of them, are qualitatively different from the old ones.

Some of the new PTAs focus more on reducing behind-the-border barriers than on extending preferential tariffs. Given that preferential agreements

involving such measures do not typically induce trade diversion, their systemic implications cannot be analysed using the traditional stumbling blocks/building blocks framework. Moreover, the political economy of new PTAs is different from that of preferential tariffs.

New international trade rules are being developed outside the WTO, with attendant risks of exclusion and additional trade costs arising from overlapping and possibly competing regulatory structures.

Whether and how these new challenges might be addressed is an open question. The principle of subsidiarity, which states that regulatory regimes should be as decentralized as possible, could be used to assess whether measures agreed at the bilateral or regional level need to be incorporated in a multilateral setting.

A number of different approaches have been proposed for improving coherence between PTAs and the multilateral trading system.

There may be a case for maintaining separate regimes for regional and multilateral cooperation where particular types of cooperation are more appropriately managed at the regional rather than the multilateral level. By the same token, there are issues that cannot be addressed adequately at the regional level. In between these two extremes, the coherence question arises.

Proposals can be grouped under four headings: accelerating multilateral trade opening; fixing the deficiencies in the WTO legal framework; adopting a softer approach as a complement to the existing legal framework; multilateralizing regionalism (extending existing preferential arrangements in a non-discriminatory manner to additional parties). These approaches are not mutually exclusive. They all aim at making sure that PTAs contribute to trade cooperation and opening in a non-discriminatory manner.

Lowering MFN tariffs would reduce discrimination and thereby blunt the adverse effects of PTAs. However, reducing all tariffs to zero does not seem to be politically feasible in the present context and it would not eliminate all potentially adverse effects of deeper integration measures. Moreover, the scope for far-reaching action in this domain is limited by the low average level of existing preferential tariffs.

The Doha Round includes a mandate to negotiate with a view to “clarifying and improving disciplines and procedures under the existing WTO provisions applying to regional trade agreements”. While negotiations on the procedural issues have resulted in the adoption on a provisional basis of the new transparency mechanism for regional trade

agreements, negotiations on rules have not advanced. These difficulties conform to a long-standing pattern of limited progress.

The rationale for using a “soft law” approach would be to allow WTO members to better understand their respective priorities and interests, with a view eventually to unblocking progress towards legal interpretations of particular provisions that would ensure coherence. However, the soft law approach is not without risk as soft law and hard law could become antagonistic to one another if the underlying conditions for cooperation are absent.

As a result of global production sharing, new forces favourable to the multilateralization of regionalism may have emerged. The extent to which deep integration measures in PTAs have the potential to generate the same sort of costly spaghetti/noodle bowl as preferential tariffs is still a matter for debate, but there may be a role for the WTO to reduce these transaction costs.

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Conclusions

An over-arching conclusion of this report is that regional and multilateral approaches to trade cooperation need not be incompatible, but neither can they be seen simply as arrangements that serve the same purpose or satisfy the same needs. Support for an increasingly outward-looking and inclusive global trading order has been strong in the period since the end of the Second World War, and this growing trend towards openness has manifested itself through unilateral, bilateral, regional and multilateral approaches.

The spread of deep PTAs and the weightier role of non-tariff commitments have important implications for how to evaluate the role of PTAs and how they interact with the multilateral trading system. The sheer number of PTAs and continuing momentum towards establishing more of them suggest that they are here to stay. They respond to a range of economic and political needs. Governments will need to find a coherent way of fashioning trade policy at the regional and multilateral level. This means ensuring that PTAs and the multilateral system complement each other and that multilateral disciplines minimize any negative effects from PTAs.

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Endnotes

- 1 These figures have been calculated excluding intra-EU trade.
- 2 If intra-EU trade is included, 30 per cent of world trade is preferential.
- 3 This figure is current as of 1 March 2011, counting notifications for agreements that are currently in force.