

The views expressed in this paper are the views of the authors and do not necessarily reflect the views or policies of the Asian Development Bank (ADB), or its Board of Governors, or the governments they represent. ADB does not guarantee the accuracy of the data included in this paper and accepts no responsibility for any consequence of their use. Terminology used may not necessarily be consistent with ADB official terms.

DESIGN AND IMPLICATIONS OF PREFERENTIAL TRADE AGREEMENTS

June 2007

Katrin Elborgh-Woytek and Azim Sadikov

Outline

- Definition of preferential trade agreements (PTAs)
- PTAs in a historical perspective
- Arguments for and against PTAs
- Experiences with PTAs
- Issues for PTA design
- PTAs in the CAREEC region

Definition of PTAs

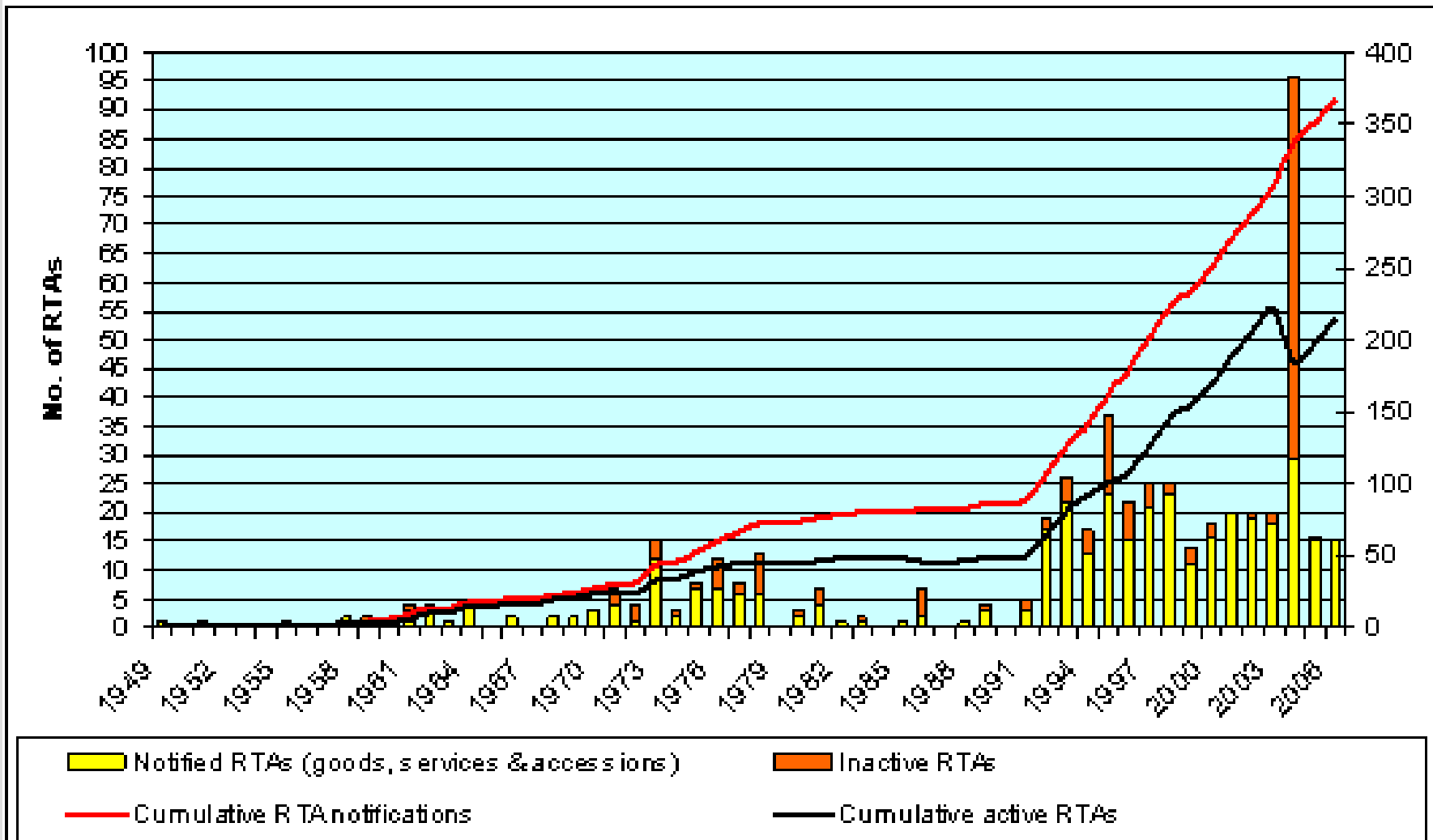
- Preferential trade agreements build on a select membership of countries in a bilateral or regional context for the purpose of enhancing factor movements. A PTA can take the form of a customs union, a free trade agreement (FTA) or another specifically-defined trade-related agreement.

Background

- Number of PTAs has increased six times over the past two decades
- Now 368 PTAs; by 2010, total of about 400 expected
- More than one third of global trade between countries operating under PTAs
- Average developing country belongs to five PTAs and is negotiating more

RTAs Notified to GATT/WTO

(Source: <http://www.wto.org/>)

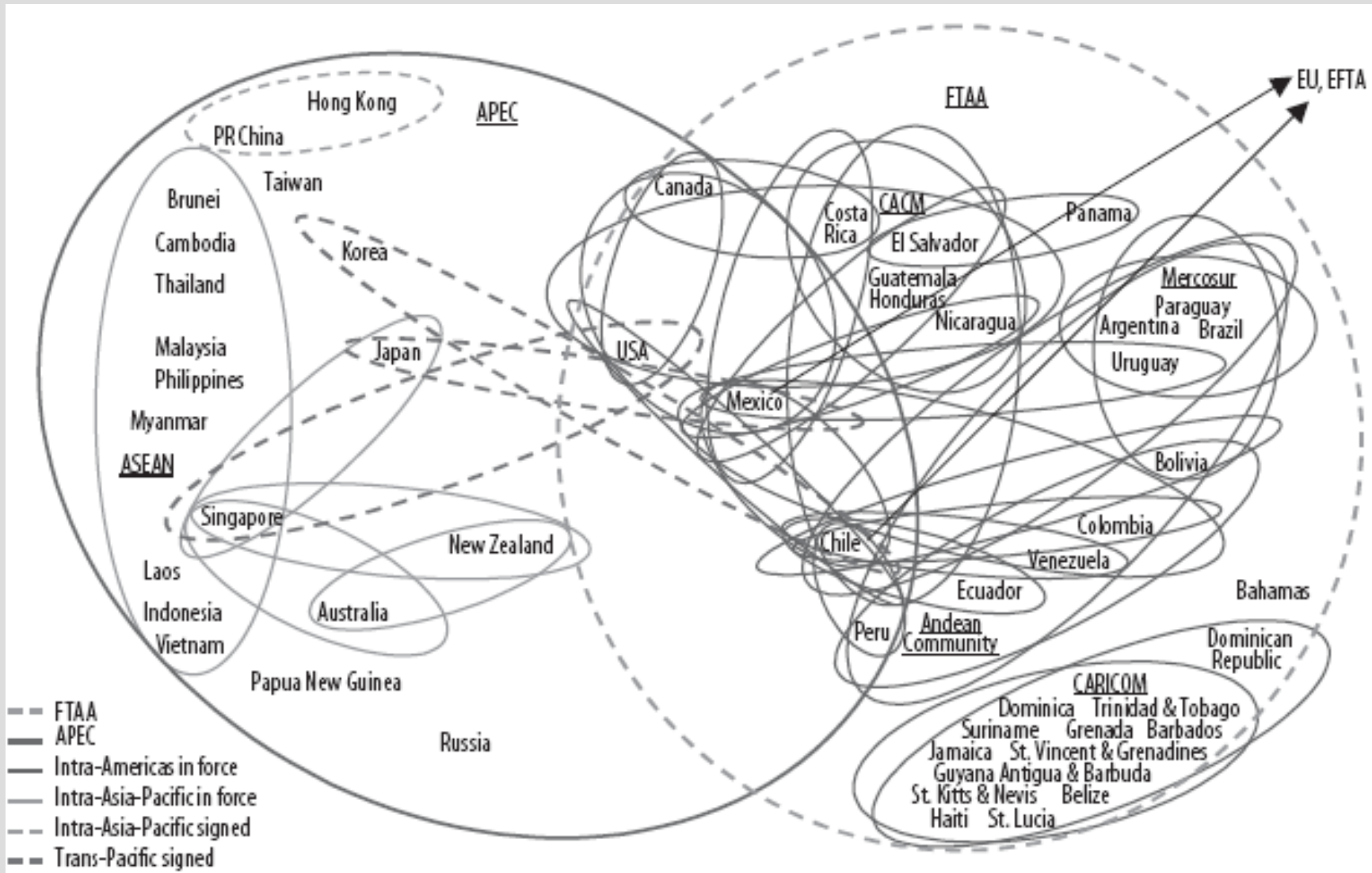


Arguments for PTAs

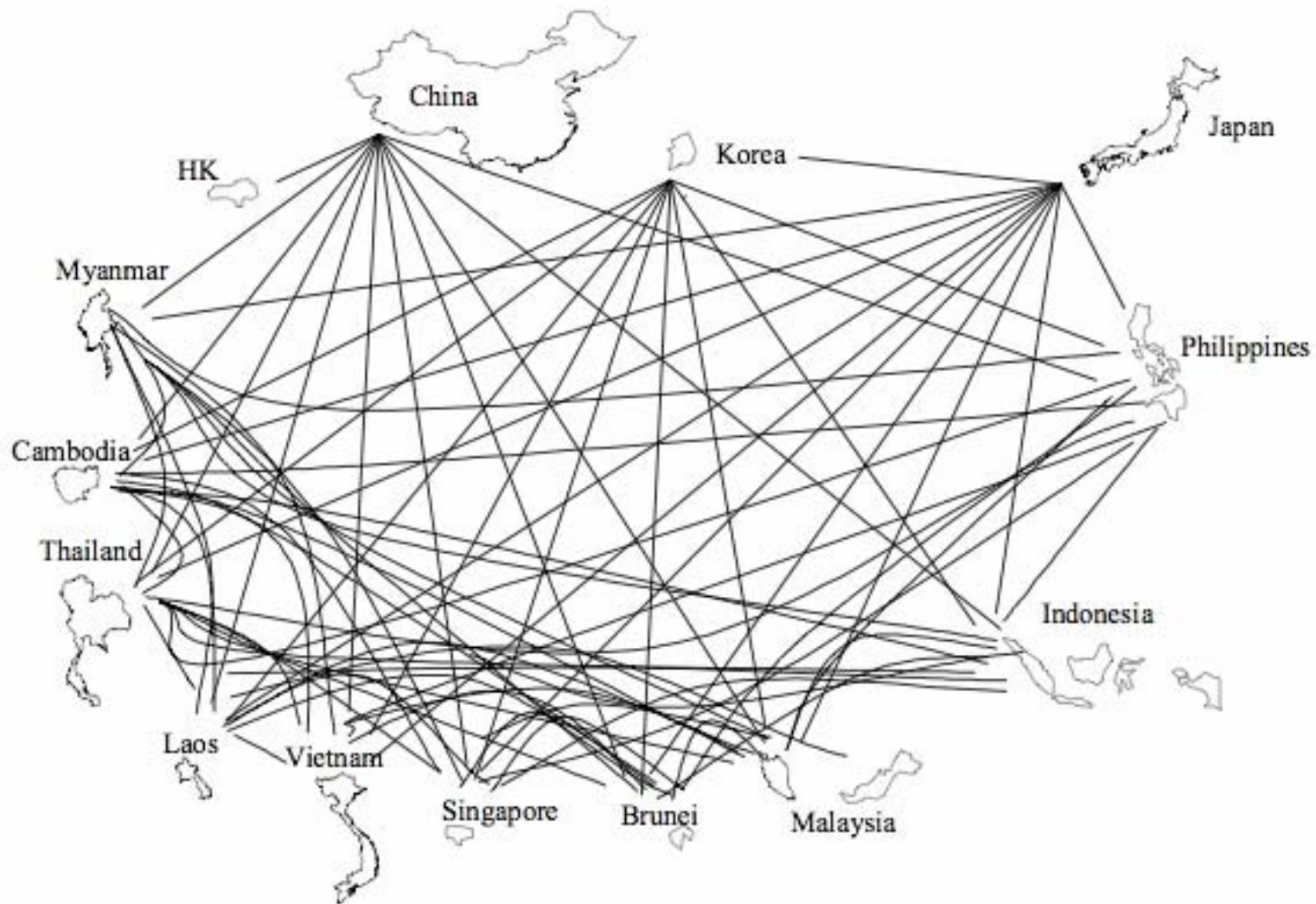
- Trade creation
- Investment and technology flows
- Commitment for future policy making
- Support for political efforts to deepen relations
- More flexibility than under multilateral agreements
- Easier to reach agreements with fewer participants

However....

- Many overlapping agreements with differing tariff schedules, rules of origin, and implementation periods lead to a so called spaghetti bowl/rice noodle bowl, resulting in higher costs and longer processing time.



Source: Devlin and Estevadeordal (2004).



Source: Richard Baldwin, *Multilateralising Regionalism* (2006)

Arguments against PTAs (1)

- Trade diversion: a PTA may result in imports from a less-efficient, higher cost PTA partner country because of lower trade taxes, instead of imports from a low-cost producer that is not a member of the PTA, resulting in welfare losses.

Arguments against PTAs (2)

- Discrimination against non-members
- Reduced incentives for multilateral trade liberalization
- Divergence from rules of multilateralism
- Vulnerabilities related to reliance on preferential access compared with set of multilateral rules

Arguments against PTAs (3)

- Potential overburdening of trade agreements with new elements and standards
- High administrative/transaction costs and confusion in overlapping arrangements
- Diversion of scarce negotiation resources to regional negotiations at the expense of global trade talks

Experience with PTAs (1)

- Theory skeptical, but most empirical studies find that trade creation dominates trade diversion
(Rodriguez-Delgado 2007)

However.....

Experience with PTAs (2)

- 1950-92 comparison of countries that liberalized broadly and those that joined PTAs shows that economies grew faster after broad liberalization, both in the short and in the long run
- Higher investment shares after broad liberalization
(Vamvakidis 1998)

Experience with PTAs (3)

- Strong evidence for reciprocity in agreements between similar countries (either developed or developing)
- Less reciprocity between developing and developed economies
(Freund 2003)

Experience with PTAs (4)

- EU: PTAs slow down multilateral trade liberalization
- Conflicts between PTA commitments and multilateral commitments
- In the absence of PTAs, EU would have lowered its MFN tariff on PTA products by an additional 1.6 percentage points (Karacaovali/Limao 2005)

Experience with PTAs (5)

- US: MFN tariffs for PTA goods remained higher than they would have been in the absence of PTAs
- NAFTA: evidence of trade creation for some sectors (including automotive parts)
- At the same time evidence of trade diversion for US imports of textile and apparel products (Fukao/Okubo/Stern 2003)

Experience with PTAs (6)

- Africa: PTAs have been largely ineffective in promoting trade and FDI because of
 - Relatively high external trade barriers
 - Low resource complementarity
 - Small market size
 - Poor transport facilities and infrastructure
 - High transaction costs (Yang/Gupta 2005)



Issues for PTA design.....

Selection of partner countries

- Differences/similarities in factor endowments
- Complementarity in trade structure
- Differences/similarities in technology
- Specialization gains versus agglomeration gains
- Size of post-agreement markets

Relations with non-members

- Aim for low external trade barriers in order to minimize trade diversion and costs for non-members
- PTAs should be complemented with moves toward multilateral as well as unilateral trade liberalization

Type of agreement

- Choice between customs union, free trade agreement, and other, more specifically defined agreements. (Customs union more welfare-enhancing than FTA as rules of origin are not needed and administrative costs may be lower.)

Consistency

- Aim for consistency between agreements, including dispute settlement mechanisms
- Aim for consistency with multilateral standards and rules (World Trade Organization, Bank for International Settlements, World Customs Organization)
- Avoid sectoral and product exemptions

Rules of Origin (1)

- Should be transparent, non-restrictive, and consistent in order to reduce compliance costs and potential for rent-seeking
- Key in determining magnitude of benefits resulting from PTAs
- Affect sourcing and investment decisions

Rules of Origin (2) – caution

- Can discriminate against countries with limited possibilities for local sourcing
- Can add to complexity and costs of trade agreements
- Can be manipulated for protective purposes

Complementary reforms

- Allow cross-fertilization between trade liberalization and economy-wide institutional reforms
- Develop business environment to maximize productivity and efficiency gains
- Allow competitive pressure on domestic producers

Supporting policies

- Ensure political support for trade agreements
- Trade facilitation measures
- Realistic implementation schedules

Impact of a PTA depends considerably on its design

- Policy makers should be careful with design of PTAs as it affects welfare of both members and non-members
- PTAs should be designed to complement and support rather than obstruct multilateral trade liberalization
- Implementation mode for PTAs (including administrative procedures) also important.

PTAs involving CAREC members:

- Asia-Europe Meeting
- Asia-Pacific Economic Cooperation
- Bangkok Agreement
- Black Sea Economic Cooperation
- Central Asian Economic Community/Central Asian Cooperation Organization
- Commonwealth of Independent States Customs Union
- Common Economic Space
- Economic Cooperation Organization
- Eurasian Economic Community
- 21 bilateral agreements

Issues for CAREC PTAs (1)

- To what extent can detailed information about these agreements be made available to the public?
- To what extent do agreements have an impact on trade flows? Is there an estimate of possible trade creation?
- Are there agreements that do not have any trade impact despite declared intentions? If yes, what are the reasons?

Issues for CAREC PTAs (2)

- Are commitments under these PTAs consistent? How do policy makers navigate potential inconsistencies?
- To what extent do CAREC PTAs comply with WTO rules?
- How does WTO membership of some CAREC countries affect regional PTAs?

Issues for CAREC PTAs (3)

- Are there estimates for the order of magnitude of preferences?
- How are the rules of origin defined in these agreements?
- Does the overlap of PTAs give rise to any administrative issues? If yes, how do the authorities respond?
- Are there effective monitoring mechanisms for the implementation of these agreements?

Issues for CAREC PTAs (4)

- Would a collective effort to rationalize these agreements be useful?
- What should the future of PTAs in the region look like?
- Bottom line: how can CAREC PTAs become more effective in terms of trade creation and in supporting moves toward multilateral trade liberalization?

