



NO. 45
November 2007



FACTS & FINDINGS



Reconciling bilateral trade agreements with multilateralism

Considerations for the EU

by Christina Langhorst

With its communication "Global Europe – competing in the world"¹ the European Commission has realigned its trade policy. While in 1999 the former Commissioner for External Trade, Pascal Lamy, had declared the multilateral approach within the framework of the WTO as the only and exclusive strategy to trade liberalisation, the new strategy (released in October 2006) regards bilateral trade agreements as an option: They make it possible to "proceed faster and further in promoting openness and integration" than is currently the case in multilateral negotiations with all WTO member states.²

Which opportunities and which risks are connected to these agreements? What can the EU do to secure its international competitiveness while at the same time maintaining the WTO's relevance?

Contact person

Christina Langhorst
International Economic Policy Coordinator
Department of Political Consulting
Konrad-Adenauer-Stiftung e.V.
Phone: +49(0)30 2 69 96-35 17
E-Mail: christina.langhorst@kas.de

Postal Address

Klingelhöferstr. 23, 10785 Berlin

www.kas.de

publikationen@kas.de

ISBN 978-393826-69-9



Konrad
Adenauer
Stiftung

1| European Commission, Directorate-General of External Trade: *Global Europe – competing in the world. A Contribution to the EU's Growth and Jobs Strategy. KOM (2006) 567.*

2| *Ibidem*



CONTENT

3	BILATERAL AGREEMENTS IN EU TRADE POLICY – THE MOTIVATION AND INTENTIONS OF THE EUROPEAN COMMISSION	
3	THE RISKS OF BILATERAL TRADE AGREEMENTS	
	▪ <i>Ambivalent Effects on Economic Welfare</i>	3
	▪ <i>The (Non-) Compliance of bilateral Trade Agreements with WTO Trade Law</i>	4
	▪ <i>The "Spaghetti Bowl" Problem</i>	4
	▪ <i>High transaction Costs</i>	4
	▪ <i>Weakening of the WTO</i>	4
	▪ <i>Neglect of Weaker Countries</i>	5
5	RECOMMENDATIONS TO THE EU	
	▪ <i>Pursuing a Defensive Strategy</i>	5
	▪ <i>The Need for a Pragmatic Approach</i>	5
	▪ <i>Simplifying Rules of Origin</i>	5
	▪ <i>Clarifying Rules for Trade Agreements</i>	6
	▪ <i>Keeping Bilateral and Regional Agreements Open</i>	6
	▪ <i>A WTO at different Speeds</i>	6
	▪ <i>The WTO as Platform and Convenor</i>	6
	▪ <i>Strengthening the WTO's Effectiveness and Relevance</i>	6



BILATERAL AGREEMENTS IN EU TRADE POLICY – THE MOTIVATION AND INTENTIONS OF THE EUROPEAN COMMISSION

While still emphasising the importance of the WTO and declaring multilateralism as the first best solution to world trade liberalisation, the EU also negotiates outside the multilateral framework. The European Commission emphasises that its bilateral agreements are not directed *against* the WTO; it rather considers them as a necessary supplement in a *trade policy mix* that contributes to improving the external competitiveness of European companies. Along with a tariff removal that goes beyond the achievements of the WTO, the agreements are supposed to include those issues that have not yet been discussed and defined at a multilateral level, such as non-tariff barriers, investment, public procurement, competition rules, and the protection of intellectual property rights (so called WTO-plus issues).

What are the reasons for this change in EU trade policy?

The lack of progress in the WTO Doha-Round makes an approach to trade liberalisation outside of the multilateral framework more attractive. At the same time, the massive economic growth in Asia has drawn attention to this region and triggered a race for markets: Many Asian countries have not only concluded bilateral trade agreements amongst each other, but also with major trading nations from beyond the region. Lobby groups have pressured the EU to maintain the level playing field for European companies and prevent competitive disadvantages in foreign markets. Moreover, with the beginning of the new millennium, the U.S. has come to regard bilateral trade agreements as one possible instrument of liberalisation that competes with the multilateral approach. Just recently the U.S. has signed agreements with South Korea, Peru, Colombia, and Panama.¹

The EU is particularly seeking partners with large and fast-growing economies, featuring high levels of protection.² Moreover, the EU takes into account whether potential partners have already concluded agreements with its competitors. According to these criteria, South Korea, the ASEAN (Association of Southeast Asian Nations), India, Russia, and the Gulf Cooperation Council have been identified as potential partners. Negotiations with South Korea and India are already under way, and the Commission has received the authority to negotiate with ASEAN.

The EU is pursuing a comprehensive approach towards South Korea, seeking trade liberalisation in as many sectors as possible. South Korea, however, has signalled its intention to partly exclude agricultural products from the bilateral liberalisation talks. For the EU, the most crucial sectors will be automobiles, chemicals, and machinery. A number of WTO-

plus issues such as standards, intellectual property, and subsidy rules are also being discussed. South Korea is the EU's fourth largest non-European trading partner with a bilateral trade volume of more than 60 billion euros in 2006. The envisaged agreement is expected to raise the volume of trade considerably: Even in a moderate scenario of liberalisation, EU exports to Korea are likely to increase by almost 50 percent and South Korean exports to the EU by 36 percent.³

Concerning India, the EU is not only the country's most important trading partner with a trade volume of almost 50 billion euros in 2006, but also its most important foreign investor accounting for almost 20 percent of foreign direct investment. Gains from bilateral cooperation can be considerable, essentially depending on the degree of integration. Investment flows from the EU to India and vice versa could increase by up to 30 percent.⁴

By 1999 the EU had concluded a number of bilateral trade agreements, for example with Chile, South Africa and Mexico. These agreements, however, concerned neighbouring countries likely to join the European Union in the future; or those states where a closer cooperation was considered as being politically important. The agreements with the African, Caribbean and Pacific Group of States (ACP countries) were established in order to support the economic development of these countries: The EU has unilaterally opened up its markets towards these countries.⁵

THE RISKS OF BILATERAL TRADE AGREEMENTS

Although academic literature has analysed extensively the effects of bilateral trade agreements,⁶ the main results will be subsumed with reference to the EU.

Ambivalent Effects on Economic Welfare

Compared to welfare-enhancing multilateral trade liberalisation, bilateral trade agreements have ambiguous economic effects: On the one hand, they promote the exchange of goods between the participating countries so that welfare increases. The tariff reduction results in falling prices which in turn stimulate the mutual demand in goods of the participating countries and lead to a higher volume of trade between these countries (*trade creation*).⁷

On the other hand, preferential agreements by definition exclude a large number of countries. This leads to a loss in welfare, also for those countries actually taking part in the agreement: When the most efficient suppliers are located in countries that are *not* part of the trade agreement, less efficient suppliers within the agreement are favoured only as a result of the selective tariff removal between the partner countries (*trade diversion*). If these negative effects for



members and non-members exceed trade creation, welfare on a global scale might decrease.

From an economic perspective the EU's choice of potential partners featuring high levels of protection could imply negative effects. This would especially be the case for an agreement with India where tariff levels are particularly high.

This negative effect is likely to be reinforced by a number of other effects:

- Once concluded, bilateral trade agreements are likely to remain closed to other countries. The mutual benefit – or rather the fear of losing this benefit – causes the member countries of a bilateral agreement to adhere to the mutually granted preferences.
- It has been observed that – having entered into bilateral agreements with the most powerful economies – countries have raised their external tariff rates towards other countries (e.g. Israel has raised its applied tariff rate after agreements with the U.S. and the EU).
- A third country that is affected by trade diversion is likely to react by raising tariffs towards the members of the free trade area. This response is likely to lead to further welfare losses and an increase in protectionism.

The (Non-) Compliance of bilateral Trade Agreements with WTO Trade Law

In order to avoid trade diversion the WTO's trade law offers a framework for multilateral negotiations. Based on the fundamental "*principle of non-discrimination*" it stipulates that the same privileges one country grants to *one* trading partner must be extended to all others. This is also known as *most-favoured-nation (MFN) treatment*. De facto bilateral trade agreements violate this principle as they grant certain tariff preferences only to one or a few selected countries. However, WTO trade law permits bilateral agreements when the negative effects involved are not so extensive. This is more likely when "substantially all the trade" between the economies that participate in the agreement is liberalised and as long as "they do not involve an increase in the level of overall protection against third countries", as stated in article 24 of the General Agreement on Tariffs and Trade (GATT). This article, however, neither clearly specifies what is meant by "substantially all the trade" nor is it consistently enforced by the WTO.

The "Spaghetti Bowl" Problem

In a bilateral trade agreement it is necessary to define a set of conditions that identifies a good as originating from a member country of the agreement. Otherwise there would be no proof that it merits the preferential tariff treatment.

These conditions are defined in the *rules of origin* that are negotiated with each trade agreement. Due to increasing trade in intermediate goods it is fairly complicated to define the *nationality* of a completed good. Rules of origin usually define that at least a certain share of the good's value must have been produced or processed in the country concerned (*minimum content threshold*). In the EU's agreements a product attains the status of origin if the processing in this country leads to a change of the good's customs code.⁸ With most of its partners the EU has established a system of harmonised rules of origin which is called the *Pan-Euro-Mediterranean-System*. It defines certain standard regulations but also includes a number of exceptions for specific sectors that are granted special protection, e.g. textiles.

As rules of origin are subject to negotiation of each trade agreement, they differ from case to case and form a complex network of regulations.⁹ The more restrictive the definitions of origin are, the more likely they are to become an additional source of trade diversion (in this context it is also called *trade deflection*). Restrictive rules of origin de facto force a certain minimum share of a good to be produced within a certain country, possibly omitting more efficient producers of intermediate goods from third countries. Rules of origin therefore act an obstacle to trade and can easily be misused as instruments of protectionism.

High transaction Costs

The network of bilateral agreements and the particular regulations involved become more and more difficult to handle the more such agreements are concluded. Hence, they considerably increase the costs of trade administration and information compared to a situation of multilateral liberalisation where basically the same conditions apply to *all* trading partners. This is a burden especially for small and medium-sized enterprises forced to spend scarce resources on the observation of different regulations. Taking into account that as a result of the increasing division of production processes one good might cross a border several times at different stages of production, the rise in transaction costs becomes even more severe. These expenses can counteract the trade-creating effects of tariff removal. Multilateral negotiations could also be more complicated as many different regulations might be hard to harmonise.

Weakening of the WTO

Negotiations outside the framework of the WTO weaken the fundamental set of rules for world trade. If the legal certainty of the multilateral system is undermined by bilateral trade agreements, countries are likely to become more and more reluctant to enter into multilateral negotiations. A further development and enhancement of the multilateral approach



is no longer guaranteed and trade policy would lose transparency, becoming arbitrary, and unpredictable, finally hampering international economic integration. Furthermore, lobby groups will not be eager to pursue negotiations within the WTO if they can successfully support bilateral agreements which satisfy their particular interest.

A loss in relevance of the WTO is likely to weaken the significance of its dispute settlement body that has developed into a powerful instrument of international arbitration by helping weaker countries to enforce their rights. The introduction of the negative consensus (verdicts are valid as long as they are not vetoed unanimously by all member states) has increasingly prevented misuse by minority interests. Although some bilateral agreements actually include mechanisms for dispute settlement (e.g. NAFTA), smaller countries can be expected to be disadvantaged when it comes to arbitration.

Neglect of Weaker Countries

In a world of bilateral trade agreements, economically less powerful countries are in danger of being neglected once powerful economies have concluded agreements with their most important trading partners. This effect counteracts the WTO's Doha mandate which is dedicated to the integration of developing countries into the world economy.

Furthermore talks on bilateral agreements drain resources that are then no longer available for multilateral trade negotiations. This is especially true for developing countries where there is a serious shortage of skilled trade negotiators.

RECOMMENDATIONS TO THE EU

Regarding the risks involved in bilateral trade agreements, the EU seems to be in a dilemma: A commitment to multilateralism would weaken the international competitiveness of European companies.

A cautiously developed trade policy however could help to overcome this apparent contradiction.

So what exactly can the EU do to avoid a shift to bilateralism and at the same time promote international economic integration? Answers and recommendations concern the alignment of EU trade policy itself but also the interests and positions it expresses within the WTO.

Pursuing a Defensive Strategy

Multilateral liberalisation is and will remain the first best solution towards achieving global free trade and as such has to be favoured. Concluding the Doha-Round is crucial and has

to be the first priority. Being the largest trading bloc in the world, the EU has to stand by its commitment to multilateral trade negotiations.

With regard to new bilateral trade agreements, the EU should follow a defensive strategy in order to maintain a level playing field for European companies instead of further accelerating the race for markets. The commitment to multilateralism is only credible if bilateral agreements remain instruments that make it possible to go beyond the WTO agenda. To offer real added value, they have to tackle the WTO-Plus issues. The recent efforts towards intensified transatlantic economic cooperation reflect the opportunity to find agreements on these issues and constitute a positive example for a bilateral approach that is in line with WTO law.

The Need for a Pragmatic Approach

Despite the criticism of bilateral trade liberalisation one cannot ignore the fact that it has always played an important role in trade politics and will most likely continue to do so. The slow progress within the WTO puts pressure on countries to proceed bilaterally. In this respect trade theory seriously discusses the option of creating regional initiatives as building blocks to global free trade, i.e. to "multilateralise" bilateralism or regionalism.¹⁰

Simply demonizing bilateralism is of no use for politics. Rather, a pragmatic approach is needed to employ the benefits of (selective) economic integration and at the same time to vitalise multilateralism. The accomplishments of world trade liberalisation are considerable and for many countries, tariffs – especially on industrial goods – are no longer the most urgent issue.¹¹

Bilateral trade agreements offer opportunities to go beyond tariff reduction and tackle WTO-plus issues. The omission of the Singapore issues in the Doha-Round reflects the fact that these topics are currently not ready for the WTO and have to be addressed elsewhere.

Simplifying Rules of Origin

In order to keep transaction costs and welfare losses low, rules of origin should be defined as simply as possible, in a consistent way, and include low content thresholds (e.g. 30 percent). The EU should define a set of standard rules and include them in future bilateral agreements. With its Pan-Euro-Mediterranean-System, the EU has taken a step towards reducing the complexity of rules of origin. Nevertheless, the system is still considered costly and trade-deflecting. With regard to a possible agreement with ASEAN in particular a standard set of rules of origin would be essential to avoid trade deflection.



Harmonising rules of origin on a multilateral level could lower transaction costs for trading firms and confine hidden protectionism. The WTO Agreement on Rules of Origin is a move in this direction but it needs support and commitment from the WTO member states. The EU should take serious action to push this process.

Clarifying Rules for Trade Agreements

The EU's focus on bilateral trade agreements with countries featuring high external tariffs raises the probability of trade diversion. In order to reduce welfare losses from regional or bilateral agreements, the WTO rule "substantially all the trade" of Art. 24 GATT has to be specified. A clear and easy to compute share of trade has to be defined as a binding standard for *all* preferential trade agreements. The EU should – jointly with the U.S. – use its political leverage and push for WTO talks on rules for regional trade agreements.

As long as no clear rules exist, a commitment to a share of 90 percent of tariff lines and 90 percent of the volume of trade – excluding no major sector – would not only be likely to meet the WTO's interpretation of Art. 24 GATT but also set an example. The EU should also make sure that its trading partners do not increase tariffs towards third countries.

If these criteria cannot be met, the European Union should seriously consider cancelling the negotiations.

Keeping Bilateral and Regional Agreements Open

A radical concept to avoid trade diversion and at the same time ensure access to foreign markets is to keep trade agreements open. This means to combine bilateral or regional liberalisation with the non-discrimination principle of multilateralism. Every country willing to do so would be able to join a trade agreement. The most pragmatic approach seems to include a *conditional non-discrimination principle*, which means that each accessing country would have to apply the conditions of reciprocal liberalisation laid out in the agreement. If not, it would be excluded from preferential market access. In this respect, one should seriously consider keeping the recent process towards a transatlantic marketplace open to further members, such as Japan; even though it is not specifically a trade agreement.

A WTO at different Speeds

To avoid the negative effects of bilateral agreements and to achieve faster progress than on the multilateral level, the EU should consider pursuing sectoral agreements. These agreements would include a specific sector only and could be negotiated by several countries within the multilateral framework of the WTO. Although this would introduce a *WTO of*

different speeds it could be a way of maintaining the organisation's relevance and effectiveness.

A positive example for such an agreement is the *Information Technology Agreement (ITA)* that was negotiated by several countries under the umbrella of the WTO and signed in 1996. The member states agreed to adapt a fixed tariff rate of zero percent for a group of IT goods and to apply the non-discrimination principle. They also defined a *critical mass*, i.e. a minimum share of world IT trade that had to be affected by the agreement, namely 90 percent. Thus far 70 countries have signed the agreement that accounts for 97 percent of world IT trade. Due to the MFN principle other countries benefit as well. As the ITA stays open to new members, it also meets the criteria of an open trade agreement.

The WTO as Platform and Convenor

Open and sectoral trade agreements, along with the harmonisation of rules, are fields where the WTO can demonstrate its relevance and effectiveness in a different way than before: It could take the role of a *convenor* that offers the framework and expertise in trade liberalisation that occurs – up to a certain extent – outside the multilateral forum today. In doing so, the WTO could ensure transparency of concluded agreements and supervise their openness. It could also advise negotiating parties and provide its know-how. By supporting this new role, the EU could strengthen the WTO and prevent it from turning into a mere bystander.

Likewise, it could become a forum for discussing and coordinating WTO-plus issues in order to prevent individual solutions in bilateral agreements becoming *dead ends* at some time in the future. The recent ambitions, however, to include these issues in the WTO's negotiation rounds run the risk of undermining the organisation's effectiveness and jeopardise the target of trade liberalisation.

Strengthening the WTO's Effectiveness and Relevance

Due to the diverging trade policy interest of its member states, the Doha-Round currently faces a difficult situation and even the threat of failure. Pascal Lamy recently emphasised that the world faces "global problems" but only has "local governments".¹² Supranational power given to the WTO could help to remove this discrepancy, for example in the form of a Commission that would be able, to a certain degree, to act independently of the member states' national interests. A first step could be to strengthen the position of the Director General and to provide further competences for the guidance of multilateral trade negotiations. The EU, being the prominent organisation with supranational elements in its framework, could be the best promoter of such a reform.



- 1| *Those are, however, still subject to congressional approval.*
- 2| *Ibidem page 11.*
- 3| *Francois, Joseph F. / Copenhagen Economics : Economic Impact of a Potential Free Trade Agreement (FTA) Between the European Union and South Korea. 2007 (prepared for the EU Commission).*
- 4| *Centre for the Analysis of Regional Integration: Qualitative analysis of a potential Free Trade Agreement between the European Union and India. Sussex. 2007 (prepared for the EU Commission).*
- 5| *The unilateral market opening is now transformed into bilateral Economic Partnership Agreements (EPAs) which are de facto free trade agreements with special provisions for development assistance.*
- 6| *See for instance Bhagwati, J./Panagariya, A. Preferential Trading Areas and Multilateralism – Strangers, Friends, or Foes? In: Bhagwati, J./Panagariya, A. (Hrsg.): The Economics of Preferential Trade Agreements. Washington. 1996. or Sapir, André. EC Regionalism at the Turn of the Millennium: Toward a New Paradigm? in: The World Economy, 23, Oxford. 2000.*
- 7| *The expected gains from the agreement between the EU and South Korea are based on this effect.*
- 8| *The EU is using the customs code of the Harmonized System of the World Customs Organization.*
- 9| *The Economist Jagdish Bhagwati has used the term "spaghetti bowl" in this context.*
- 10| *See Baldwin, Richard: Multilateralising Regionalism: Spaghetti Bowls as Building Blocks on the Path to Global Free Trade. Discussion Paper Nr. 5775. London. 2006.*
- 11| *Today the average tariff for industrial goods is about 4 percent.*
- 12| *Interview with Pascal Lamy in "Der Spiegel" 30/2007 dd. 23/07/2007.*