3. FTAs – advantages and disadvantages

The principal point of Free Trade Agreements is to secure trade liberalisation. While the traditional debate about FTAs is the danger that they can divert rather than create trade, the record to date suggests there has been little diversion and that FTAs and regional agreements have been effective in encouraging wider trade liberalisation. A practical advantage of FTAs is that they are quicker and easier to negotiate than multilateral agreements because fewer parties are at the table. Parties can secure advantages that are harder to win in bigger forums.

The disadvantages are twofold. If FTAs are not set up within the right framework of policies, they can diminish rather than enhance economic welfare. The second disadvantage is that they are not good vehicles for liberalising trade in sectors on which parties outside the agreement have a major influence.

FTAs as drivers for liberalisation

While multilateral agreements under the GATT and WTO have been the leading arrangements bringing greater trade liberalisation in the world economy, narrower agreements like the European Union and the Canada-US bilateral FTA have also been significant. For Australia, the Closer Economic Relations agreements with New Zealand have made important contributions in allowing Australia and New Zealand to become, in substance, a single economy.

While trade liberalisation is usually a negotiated process under which each party makes "concessions" in opening up their markets, greater access to the market for the second country is only the first gain for the first country. The second gain is the benefit to the domestic economy of reducing protection. It is similar to gains from unilateral liberalisation.

How liberalisation occurs

Bilateral trade liberalisation can be thought of as bringing changes to the participants in two ways: through diverting goods and services from countries that become disadvantaged in relative terms from the liberalisation, and by displacing higher cost goods and services. Liberalisation that displaces goods with cheaper goods is clearly preferable and it is the likelihood of some trade diversion that has brought objections to bilateral and regional free trade agreements as opposed to multilateral agreements.

Traditionally, trade benefits have been most apparent in FTAs where countries have vastly different economic structures. Comparative advantage in different areas of production allows both partner countries to gain as a result of specialisation. A refinement of this analysis (the so-called Heckscher-Ohlin model) shows how trade raises the prices of the cheaper good in each of the trading partners while lowering the prices of the scarcer (imported) good to more than offset this. This view of trade gains has been at the heart of the process over a long period – text books often described it as Australia sending primary products to England and receiving manufactures in return.

More recently, the gains stemming from the European Union and from the Australia New Zealand Closer Economic Relations Trade Agreement (ANZCERTA) have highlighted different forms of gains, or, perhaps more accurately, a different view of the same gains. There the gains were realised by countries with structurally much more in common than the traditional trade-gain theories highlighted. The gains came from intra-industry trade – the trading partners appeared to be buying and selling goods that they already made in their home countries. Two factors account for the gains from this intra-industry trade following liberalisations between countries with similar economic profiles:

- increased competitive pressures on suppliers that were previously less heavily challenged in their home markets;
- a variation of the traditional comparative advantage gains that takes advantage of the increased specialisation of modern production and the increased number of stages through which materials are transformed prior to reaching the final consumer.

Freeing up trade between countries with similar economic profiles often produces benefits without some of the disruption that sometimes accompanies agreements between countries with radically different economies. Where firms face increased competition from rivals producing similar goods and services, they usually lift their performance to the benefit of consumers in all participating countries. This is most vividly seen in the European motor industry.

In other cases, the increased intra-industry trade brings improvements through *de facto* increased scale economies. For example, in the European case, it has led firms to specialise in parts of a production process that they previously undertook in its entirety, or to concentrate on particular market segments.

The problem of trade diversion

A trade bloc created by a free trade agreement leads to expanding trade through trade *creation* and trade *diversion*. The latter stems from sales won at the expense of third country suppliers, which become less competitive purely because they face a tariff barrier that does not apply to suppliers within the new free trade area. Such increased trade actually reduces the economy's overall efficiency. It is trade creation, whereby less productive activities in the partner contract and the more productive expand, that defines many of the benefits of the agreements. This in turn depends on:

- the relative importance of each country as a trading partner in a liberalised trade environment;
- the size and extent of existing trade barriers;
- the degree to which the effect of removal of barriers to trade between members results in more or less access overall by trading partners into the free trade area, and
- the degree to which a reduction in trade barriers between the two countries causes industries to expand that are relatively high cost on a global scale.

The final calculation of whether an FTA diverts or creates trade is the net balance of the diversion and creation.

Little evidence of diversion

Most recent studies of the impact of trade blocs have found that trade diversion has been less apparent than was previously assumed to be the case. A 1995 study by the OECD[1] concluded that there was no evidence that these agreements had created trade diversion. While conceding that it was in some cases difficult to assess diversion, the anecdotal evidence suggested that these agreements had probably served to stimulate trade liberalisation elsewhere, including through multilateral liberalisation.

The Australia-New Zealand Closer Economic Relations Trade Agreement (ANZCERTA) would have been a model candidate for creating trade diversion because trade barriers in Australia and New Zealand were high by OECD standards at the time of signing. However, ANZCERTA was not considered to have diverted trade because both countries unilaterally reduced their trade barriers with other trading partners in parallel with the ANZCERTA program to eliminate all trade barriers between the two countries. This obviated the risk of trade diversion.

A study by the Department of Foreign Affairs and Trade of the impact of NAFTA[2] concluded that there was no evidence that the agreement had had diversionary effects.

1 OECD, "Regional Integration and the Multilateral Trading System: Synergy and Divergence", Trade Directorate, February 1995.

According to Professor Anne Krueger,[3] the bulk of Mexican products that increased output/exports to the US rapidly under NAFTA were also the ones whose exports to other destinations grew most rapidly. She also recognised that about two-thirds of Mexico's trade was with the United States even prior to NAFTA. She goes on to say, "The maquilladora industries that were established in Mexico took advantage of the duty-free treatment on the materials component of imports re-exported to the United States prior to NAFTA." The NAFTA experience lends weight to the conclusion that Free Trade Agreements between countries with low trade barriers are overwhelmingly more likely to lead to trade creation rather than trade diversion.

Promoting liberalisation

There is an emerging body of thought that bilateral and regional trade agreements support multilateral processes of trade liberalisation, rather than undermine them. This is less an economic argument than a political one. The 1994 OECD Study referred to above reflected a general view among governments that the regional agreements had supported the broader multilateral process that was running concurrently.

It is possible to point to a number of areas where agreements to liberalise in regional fora set precedents that were followed in the multilateral negotiations. ANZCERTA demonstrated how it was possible to set disciplines to open markets for services. Officials in the then nascent negotiations in the Uruguay Round point to the demonstration effect ANZCERTA had on efforts to develop multilateral rules.

Nor is there evidence that negotiation of bilateral or regional agreements distracts governments from the task of managing multilateral negotiation. The record shows the opposite. The consolidation of the European Community under the Single Market program, and the negotiation of the US-Canada FTA and subsequently NAFTA, occurred while the Uruguay Round was being negotiated. Neither regional activity hindered achievement of very significant agreements in the Uruguay Round.

It is important to recall the circumstances surrounding this outcome. At the time there was apprehension that the world might fragment into regional trading blocs. Governments outside Europe were deeply concerned the EC Single Market program would create a 'Fortress Europe' trade bloc, and that NAFTA might lead in a similar direction. The commitment of the leading economies in Europe and North America to a successful conclusion to the Uruguay Round, and the reconfirmation of support for multilateral trade liberalisation constituted by the Uruguay Round agreements, put paid to such apprehension. This demonstrated that the interest of the world's leading economies in regional liberalisation was not at the expense of multilateral liberalisation.

2 DFAT, *NAFTA after Five*, www.dfat.gov.au/geo/americas/nafta/chpt5.html, March 2000.

3 Anne O. Krueger, "Trade Creation And Trade Diversion Under NAFTA", Baldwin conference, National Bureau of Economic Resources, August 15, 1999.

Some leading free trade economists, such as Professor Jagdish Bhagwati at Columbia University remain very uneasy at this development, in particular the preparedness by successive US Administrations to pursue bilateral and regional agreements.[4] Their apprehension serves as a form of vigilance about the risk of trade diversion. It does not amount to a case against negotiating any kind of free trade agreement, and points to the need to ensure they are negotiated within the right context.

Practical Advantages

An obvious attraction of an FTA is that members obtain preferred access to the markets of other members. As noted above, this may not produce optimal outcomes in the long term. It depends on the overall impact of the arrangements and other concurrent trade policies. Trade agreements set rules for regulating trade and trade-related activity as well as incorporating commitments to remove trade barriers. The record has shown that members of trade agreements can also secure agreements in FTAs for rules that confer advantages upon their trading partners and reduce trade irritants and restrictions that could not otherwise be secured from multilateral trade agreements.

Box 3.1 below sets out some benefits secured by the North American Free Trade Agreement (NAFTA) — USA, Canada and Mexico — and ANZCERTA — Australia and New Zealand — that were not available under the multilateral rules of the WTO or its predecessor, the GATT. These details are drawn from the comparative analysis of WTO, NAFTA and ANZCERTA set out in Annex 7.

Practical disadvantages of FTAs

FTAs only confer economic advantages when they are negotiated with countries which are significant trading partners. The relatively modest level of trade with some prospective partners has in the past been one factor deterring the Australian Government from pursuing individual FTA proposals.

FTAs also increase the complexity of the international trading system and can raise transaction costs for business. For example, complicated rules of origin are required to prevent third country product entering via the other party. With different rules negotiated under different agreements, enforcement of these rules and compliance with them by business can be a complicated task. Business also has to take into account the different dispute settlement mechanisms as well as different standards regimes and other harmonisation arrangements.

The negotiation of RTAs is resource intensive and there can be an ‘opportunity cost’ in devoting resources to bilateral or regional, as opposed to multilateral. The NAFTA agreement, for example, was over one thousand pages long and required the establishment of more than two dozen committees and working groups.

4 Bhagwati, Jagdish, “Regionalism and Multilateralism: an Overview” in De Melo and Panagariya (eds), *New Dimensions in Regional Integration*, Cambridge University Press, 1993.

Box 3.1 **Benefits secured from FTAs not available under WTO agreements**

Measure	Beneficiary	Agreement
Phase out over 15 years of most barriers in the US to agricultural exports	Mexico	NAFTA
Removal of all tariff and non-tariff restraints on all traded goods	Australia New Zealand	ANZCERTA
Removal of export subsidies on all bilateral agricultural exports	Canada USA	NAFTA
Agreement not to distort bilateral trade with subsidies.	New Zealand Australia	ANZCERTA
Right for investors to receive national treatment	Canada USA Mexico	NAFTA
Freedom from anti-dumping penalties	Australia New Zealand	ANZCERTA
Rights to have anti-dumping penalties reviewed	USA Canada Mexico	NAFTA
Harmonisation of standards and conformance procedures	Australia New Zealand	ANZCERTA
Removal of restrictions on most traded services	Australia New Zealand	ANZCERTA

Source: Annex 7