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Mark S. Manger
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1 Introduction

In late September 2006, a short letter arrived at the Secretariat of the World Trade Organization in Geneva that formally announced the entry into force of the United States–Bahrain Free Trade Agreement, bringing the number of notified trade accords to 200. With every preferential trade agreement (PTA) – an arrangement that liberalizes trade between member states only – the principles of multilateralism and non-discrimination in international trade as embodied by the World Trade Organization (WTO) lose more relevance. When the letter was received, already more than half of global commerce was conducted under the rules of one PTA or another.

How different the world of international trade diplomacy looked only twelve years earlier. After almost eight years of negotiations, ministers of 109 countries shook hands in Marrakesh on April 15, 1994, on the occasion of the signature of the most ambitious multilateral trade agreement in history. The final deal brought agriculture into the domain of the General Agreement on Tariffs and Trade (GATT) and created the General Agreement on Trade in Services (GATS), a GATT counterpart for services, by then making up a third of global commerce. Most importantly, it established the World Trade Organization itself, a formal international institution with its own staff and seat in Geneva (Barton *et al*. 2006: 93).

The mood was euphoric. US Vice-President Al Gore, who had flown in to address the meeting, called the deal "truly momentous." Peter Sutherland, the Irish Director General of the General Agreement on Tariffs and Trade, said that he was tempted to dance a jig on the table to express his joy.[1] Multilateral liberalization appeared to be firmly established. During the 1980s and early 1990s, many developing countries had embraced an open trade policy and applied for GATT membership.

[1] This depiction of events draws on an article in the *New York Times*, April 16, 1994.

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They were joined by central and east European states that had emerged from communist rule. Even China was in negotiations for accession. Yet, today, multilateral trade negotiations under the auspices of the WTO seem to be little more than a sideshow. Since the early 1990s the world has seen an explosion of preferential trade agreements. Notably, the majority are North–South agreements that bring together economies of vastly different sizes and levels of development.

The rapid proliferation of North–South PTAs is striking since, compared with even minor tariff reductions on a multilateral basis, they do not create much trade. The commitments to lower barriers they embody are dwarfed by the unilateral steps taken by many emerging market countries. Thanks to successive GATT negotiation rounds, most-favored-nation (MFN) tariffs[2] are at historically low levels. Trade economists are divided over whether PTAs improve welfare (compare *inter alia* Freund 2000; McLaren 2002), but almost unanimously judge them a second-best solution to multilateral and unilateral liberalization.

But arguments against PTAs are not just theoretical. The multitude of agreements creates a patchwork of different rules that burden exporters with paperwork and bureaucracy, leading the chairman of Li & Fung, Hong Kong's largest trading company, to pronounce in the *Financial Times* that "multilateralism creates value, bilateralism destroys value."[3] If the complex rules are hard to follow for major trading firms, then they are simply too costly to comply with for most companies from developing countries. One study shows that only half of the imports into the European Union (EU) from least-developed countries make use of the full tariff preferences available. The other half is covered by MFN tariffs, since exporters would rather pay the higher duty than deal with the documentation requirements (Brenton 2003).

Especially for developed countries, individual PTAs with developing economies offer very limited export prospects. Even Mexico, a country with a population of over 100 million, registered annual vehicle sales of only 500,000 in 2005 – about the size of the auto market of Los Angeles. Many PTAs specifically exclude those goods in which developing countries have a comparative advantage. Conventional exports

[2] MFN tariffs are the duties countries charge on a non-discriminatory, unconditional basis. Art. 1 of the GATT requires its signatories to grant market access equal to "the most favored nation" unless, of course, they sign a preferential agreement.

[3] *Financial Times*, November 3, 2005.

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are an unlikely explanation for the popularity of North–South PTAs. Why, then, the sudden proliferation of these preferential trade agreements? Why do major economic powers sign agreements with partners that bring little market size and overall welfare benefits?

This book argues that foreign direct investment (FDI) by multinational firms and the attendant trade are key driving forces of North–South PTAs. FDI flowing from developed to developing countries changes the incentives for governments in both, motivating them to pursue bilateral and regional options because they satisfy the political demands of multinational firms. As these firms invest in developing countries to produce goods for developed markets, they call for the reduction of barriers at home and abroad because it facilitates vertical integration, or the specialization of production according to technological capacity and labor cost. Firms produce high-end goods in the North and low-end products that require cheaper labor in the South, and ship these goods to the other partner.

Yet many multinational firms no longer see the WTO as the best way to meet their trade liberalization needs. Unlike multilateral deals, preferential agreements for trade and investment offer a special benefit: They can be used to raise the barriers for competitors from non-member states. Without such barriers, North–South liberalization would attract "beachheads" of FDI from outsiders, turning the developing country into a back door to the market of the northern partner. To make North–South liberalization politically feasible, governments therefore erect new barriers as they tear down others.

Raising barriers requires the use of discriminatory tools. Since nearly all recent PTAs are free trade agreements (FTAs)[4] in which the members set their own external tariffs, they require rules to determine the origin of goods. In the absence of such rules, goods would simply be imported via the partner country with the lower tariffs. These rules of origin (ROOs) can be designed to the disadvantage of outsiders and to provide protection for insiders. A related mechanism is at work in the service sector, which attracts a large share of FDI. Market and regulatory structures penalize late entry and provide incentives for preferential liberalization.

[4] Throughout the book, I refer to preferential agreements in general as PTAs, and to FTAs only in specific cases where the legal text uses the term. This applies to the FTAs between Japan and Mexico, Chile and the United States, the EU and Japan, and Japan–Thailand and Japan–Malaysia.

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North–South PTAs thus trigger an endogenous dynamic unanticipated by earlier proponents of preferential trade agreements: other countries conclude defensive agreements with the host country out of fear of being shut out of markets and production locations. North–South PTAs are therefore not just a beauty contest among developing countries over who is the most open to foreign trade and hence to be rewarded trade agreements with rich partners, as the former US Trade Representative (USTR) Robert Zoellick suggested when he coined the term "competitive liberalization." It is a contest between major economic powers to gain access to emerging markets and important production locations, to impede such access for competitors, and to restore it when others have moved first.

This book offers a political economy account of the endogenous competition driving much of the proliferation of North–South PTAs. The approach assumes that governments decide their policies in response to pressures from organized societal groups. Although political variables may shape the decision to pursue PTAs, I emphasize the economic incentives that cause their proliferation, since even a PTA concluded for non-economic reasons is likely to have redistributive effects within and between countries. At the centre of the argument is a model of trade policy formation at the domestic and systemic level. Domestic sources of trade policy, in particular the interests of multinational firms, lead to policy outcomes at the international level. Since these interests not only influence the decisions to seek trade agreements, but also the design of PTAs, they have (at times unintended) consequences that reverberate abroad. Multinational firms in other countries in turn seek to influence the trade policy choices of their home government.

Through several case studies the following chapters explain how this process results in a spiraling model of more and more PTAs. The in-depth case studies cover the North American Free Trade Agreement (NAFTA) and the two defensive agreements with Mexico signed by Japan and the EU. I then apply the framework to several cases of North–South PTAs concluded in recent years: Japan's FTAs with Thailand and Malaysia, and the FTAs with Chile signed by the United States, the EU, and Japan.

Unequal partners: the proliferation of North–South PTAs

If trade liberalization is defined as the lowering of tariff barriers, the GATT should be considered a spectacular success. Negotiations have

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cut down manufactured goods tariffs on MFN basis from an average of over 50 percent to between 5 and 10 percent. Most manufactured imports into the industrialized countries face near-zero or no tariffs. In the light of this achievement, the sheer number of North–South PTAs signed in recent years is particularly striking. A closer look at the institutional features of the global trade regime and the character of recent PTAs shows that today's agreements coincide with profound changes in the world economy. Developing countries have reintegrated with the global economy, causing changes in the character of investment in these "emerging markets" and affecting the multilateral trade regime in turn. As such, this trend does not herald a return to the protectionist blocs of the 1930s. The scope of recent PTAs, covering new issues beyond trade in goods, their character as partnerships between countries of unequal levels of development, and their often "extra-regional" geography set them apart from past trade arrangements.

The experience of the interwar years, when retaliatory tariffs led to the creation of protectionist blocs, provided the initial impetus for the United States to support the creation of the GATT. Based on the constitutive norm of non-discrimination as expressed in MFN tariffs, Article XXIV of the GATT stipulates that regional integration measures have to conform to three standards. First, they should cover substantially all trade. Second, they should liberalize trade between the members within a reasonable time frame. Third, they must not raise the barriers against third parties above the initial MFN level at which tariffs are "bound" by GATT members. However, many developing counties apply much lower tariffs than their bound rates, leaving room for increases in tariff rates. Moreover, no similar clause exists with regard to non-tariff barriers such as rules of origin or the regulation of FDI. Although PTAs have to be "nested," or made compliant with the overarching GATT/WTO regime,[5] the weak disciplines of Article XXIV give states considerable freedom in creating discriminatory measures.

Because of the leeway given by the GATT, PTAs vary in their coverage of trade and in the inclusion of the flows of the factors capital and labor. A considerable number of agreements fall under the "enabling clause" of the GATT that allows developing countries to sign agreements among themselves with generous time frames for tariff reduction, often

[5] See Aggarwal (1998) and Aggarwal and Urata (2006) for an analysis of the "nesting" of multiple international regimes.

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resulting in little or no actual liberalization. Many recent PTAs have this declaratory character. Other agreements only reaffirm existing tariff-free trade between states that previously belonged to the same political entity, as in the 1992 FTA signed by Slovakia and the Czech Republic, or agreements between former Soviet republics. Finally, some agreements are superseded by later PTAs, while others are suspended for political reasons.[6]

Counting only the PTAs in force and joint GATS Article V (trade in services) and GATT Article XXIV (trade in goods) agreements such as NAFTA as a single institutional package, we arrive at a cumulative figure of about 170 PTAs in 2008. Taking a minimum difference of US$15,000 in per capita gross domestic product (GDP) in purchasing power parity terms as threshold to count a country as "developed," about 100 are "North–South PTAs" – here used as a shorthand, although some "Southern" countries such as Macedonia and Armenia (partners of the EU and Switzerland, respectively) would be better characterized as economies in transition. This figure is much smaller than is to be expected based on the number of countries involved, since the EU has a common external trade policy and the European Free Trade Area (EFTA) member states[7] usually negotiate agreements jointly. This study focuses on the growing subset of PTAs between pairs of countries that are highly unequal in their level of development and the size of their economies.

Figure 1.1 is a graph of the growth of these agreements over time. Until 1991, North–South PTAs were limited to a handful of agreements, mostly between the European Community and its close neighbors, such as the EC–Malta FTA of 1971. The turning point came in the early 1990s, when countries in Latin America and many former communist countries began to seek PTAs, and when the United States, the creator of the GATT regime and the biggest importer, turned to North–South agreements. By the mid-1990s, the trend was in full swing.

Notably, the number of North–North agreements has in fact decreased in recent years, as several central and east European countries have joined the EU (Pomfret 2007). North–South agreements as defined

[6] Whalley (2008) offers a thorough overview and warns against alarmist double-counting of PTAs.
[7] Iceland, Norway, Switzerland, and Liechtenstein.

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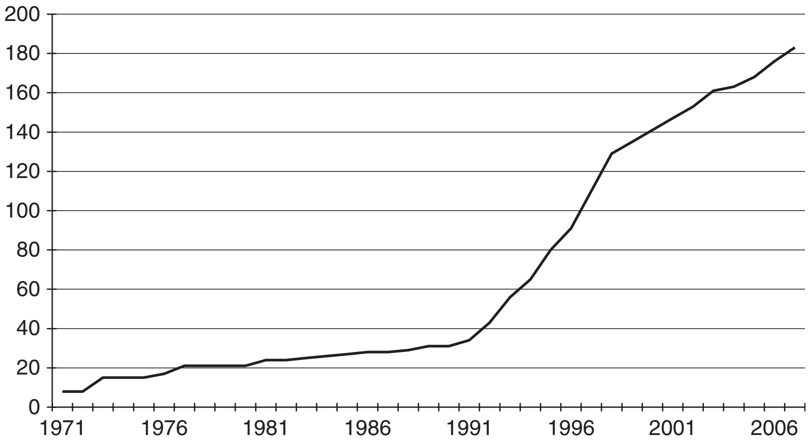

Figure 1.1 Growth of North–South PTAs, 1971–2007.
Source: WTO Secretariat; McGill Trade Agreements Database, http://ptas.mcgill.ca.

here are experiencing the fastest growth of all PTAs.[8] Almost all are classified as FTAs rather than as customs unions, the sole exception being the 1996 EU–Turkey agreement.

Advanced developing countries such as Chile, Mexico, or Thailand are preferred partners in today's agreements. Prior to liberalization in the developing world, commercial interests from the North were limited to resource extraction, "tariff-jumping" investment by multinational firms, or, in the case of many "developmental states," closely circumscribed domains of export-oriented production. Liberalization creates new opportunities and thus the incentives for interested parties in industrialized countries to lobby for agreements to secure preferential access.

In Latin America, unilateral liberalization represented the first step in overcoming the legacy of import-substitution industrialization.[9] During most of the 1950s–1980s, multinational firms produced outdated products, protected by high tariffs, for domestic sales in markets such as

[8] See also Fiorentino *et al.* (2006) for a slightly different classification that reaches a similar conclusion.
[9] Imports were to be substituted by domestic production, protected by high tariffs and quotas on imports. For a succinct description of these policies and their unintended effects, see Krueger (1995a), esp. chapter 1.

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Mexico, Brazil, and Argentina. Using various performance requirements, for example the sourcing of a percentage of inputs or mandatory export of a share of the production, governments attempted to harness the benefits of foreign capital (Caves 1996; Greenaway 1992). To compensate multinational firms for high tariffs and host country requirements, governments struck deals that sheltered investors from competition and offered economic rents (Evans 1979). While the provision of services remained in the hands of governments, the high tariffs and restrictions made exports and investment by smaller firms from developed countries infeasible. FDI sought markets, but under the specific conditions of the import-substitution policy of the host country. As Latin American countries began to liberalize in the late 1980s and early 1990s in search of foreign capital, they became attractive for a different kind of investment integrated with world markets.

Despite important differences from Latin American countries, Asian "developmental states" (Wade 1990) attracted similarly inward-oriented FDI. Multinational firms, in this case mostly from Japan, enjoyed exclusive market share arrangements for their products. While export-oriented investment caught the attention of many scholars, it was nearly always limited to a few industries – mostly computer parts and consumer electronics manufacturing in east and southeast Asia, especially in Taiwan, Singapore, and Malaysia. Following the 1997 Asian financial crisis, liberalization has reached this region as well.

As other sources of capital such as bank loans have dried up, countries in both regions have been forced to compete for investment. In this competition, governments see direct investment as preferable to volatile portfolio capital flows. Table 1.1 shows the growth in total net FDI inflows since 1987.[10] From a low base of less than 10 percent of global FDI, developing countries received a growing share of capital flows during the 1990s, with a peak of almost 36 percent in 1997. Although China's share of FDI to developing countries alone made up a third on average, other developing countries received massive inflows as well. The growing share flowing to developing countries drew on a steadily larger volume of global capital: measured in constant US dollars, foreign direct investment flows have grown more than sixfold since 1987.

[10] To facilitate comparison, all dollar figures throughout the book have been deflated to constant values using the US consumer price index with the year 2000 as base.

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Table 1.1. *Net global FDI inflows and country shares*

Year	Global FDI (US$ billion)	Country shares as a percentage: High-income countries	Developing world	Of which China
1987	178	90.3	8.1	1.8
1988	209	85.2	12.2	2.0
1989	248	86.6	11.9	1.7
1990	251	84.2	11.9	1.7
1991	186	73.7	22.1	2.8
1992	194	67.7	29.8	6.6
1993	249	66.4	30.3	12.5
1994	275	60.3	35.4	13.6
1995	357	64.5	31.7	10.9
1996	398	62.3	34.1	10.7
1997	491	59.6	35.9	9.4
1998	722	71.4	24.2	6.3
1999	1,119	79.5	16.2	3.5
2000	1,518	83.5	10.9	2.5
2001	779	72.5	21.7	5.5
2002	708	75.1	21.8	6.7
2003	608	69.7	25.0	7.3
2004	708	62.9	29.1	7.1
2005	929	66.4	27.5	7.5
2006	1160	65.8	27.2	5.8

Source: World Development Indicators Online 2008. All figures deflated to constant US$2,000.

Moreover, the raw figures obscure qualitative differences. While high-income countries still receive close to two-thirds of total direct investment, much of this FDI consists of the acquisition of existing firms. A larger proportion of FDI to developing countries is made up of "greenfield investment" that leads to the construction of new production facilities. As is repeatedly stressed in UNCTAD reports (e.g. 2004a), FDI is by now the most important source of foreign capital for developing countries.

In various ways these investment flows are linked to international agreements. For developing countries, combined free trade and investment agreements offer an institutional package that locks in unilateral

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liberalization and provides guarantees for investors beyond WTO commitments (Fernández and Portes 1998). These benefits resemble those promised by the growing number of bilateral investment treaties (BITs), another product of the competition for foreign capital (Elkins *et al.* 2006). In addition to these advantages, trade agreements with an industrialized partner, even with only modest tariff reductions, give a developing country an edge over competitors with similar factor endowments (Ethier 1998a, 1998b, 2001). Both benefits explain why developing countries seek bilateral agreements with developed countries.

Less obvious is why these developed countries should take up the offer. Most developing countries are negligible export markets. In terms of national income, Mexico offered US firms barely 6 percent additional market size when NAFTA entered into force.[11] Foreign direct investment, however, creates powerful incentives for multinational firms to offer political support for PTAs beyond what the potential for conventional exports would lead us to expect.

Following the reintegration of many developing countries into the world economy, they attract manufacturing FDI to serve as export platforms to (mostly) developed-country markets. Sometimes, labor-intensive stages of production are moved to developing countries. At other times, multinational firms relocate the manufacturing of mass-market goods to low-cost countries, but keep the production of key components and high-end products at home. In addition, manufacturing FDI entails exports of machinery (capital goods) and inputs such as parts (intermediate goods) to the FDI host. One of the most important purposes of PTAs is to liberalize the trade in goods generated by FDI – much more so than the regulation of FDI in manufacturing itself or the reduction of tariffs on other exports.

Manufacturing FDI also creates a market for related services, for example insurance of exports or financing of direct investment. Moreover, since most developing countries have only recently begun to open their financial and telecommunications service markets, FDI in services represents a considerable share of the capital flows to emerging markets. Provisions for FDI in PTAs therefore apply in large measure to these flows.

[11] In concrete numbers, a GDP of merely US$466 billion compared with US GDP of US$7.7 trillion, adjusted for purchasing-power parity.

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