

Regionalism And Multilateralism: What Does the Future Hold?

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MELBOURNE 17 SEPTEMBER

For at least two decades the trade policy communities of Australia and NZ - by that I mean Ministers, officials and policy-oriented academics involved in developing trade policy strategies for our two countries - have been involved in a continuing debate of some importance to our two countries.

That issue, simply stated, is the following: do we have to choose between the multilateral trading system (clearly both our countries' first priority) and regional trading agreements? By 'regional trading agreements' I mean Customs Unions such as the EU or MERCOSUR or Free Trade Areas (FTAs) which are either bilateral such as CER or plurilateral such as the AFTA among the countries of South East Asia. The strategic political and economic stakes in that debate are high.

In accepting this invitation some months ago, I had assumed that I would need to be somewhat conservative in the way I proceeded to outline this issue from a NZ perspective and that I would be giving an essentially academic presentation of the issues to this largely Australian audience. As a result of certain developments in Auckland in the margins of the APEC meeting, I am in a position to be rather more forthcoming.

For reasons I shall outline, I believe the underlying policy issue - do we have to choose between the two approaches? - has now been settled and decisively so. Trade negotiators have voted with their feet and the sound and sight of them doing so - NZ, Korea, Singapore, Chile, Mexico was very much in evidence in various Auckland hotels. Yet other economies, more significant than these, are tip-toeing in the same direction. We face interesting times.

Regionalism v Multilateralism: The Literature:

However, since there are a number of distinguished academics in the audience who have long made contributions to this evolving debate, let me start with The Theory. There are still traps, long identified in the literature on this matter, in the interface between regional trade arrangements and the multilateral system

which need to be taken carefully into account as we proceed to develop the trade policy architecture of the APEC region in particular.

These considerations have been central to the formulation of NZ policy. We have always believed that the way the international debate has been frequently characterised in, say, the op-ed pages of the *Economist* - ie are you in favour of bilateralism or are you in favour of multilateralism? - is hopelessly mis-stated. A classic false dichotomy.

There has never been any doubt about where NZ interests lay: the multilateral approach. Whether regional trade agreements help or hinder that first best approach of multilateral movement towards freer trade and strengthened markets depends entirely on the technical construction of such agreements. That in turn, of course, depends on the underlying political and economic strategy driving the formation of these agreements.

Back to The Theory. My memory of the The Theory is a little worn with age: I left the laboratory over a quarter of a century ago (a small personal miscalculation involving a very close friend and you graduate with a *PhD interruptus*). Next option: become a policy adviser.

There will have been major analytical advances since then - obviously. But if I take the public expression of distinguished academics on the matter, dumbed down for policy wonks like me, as a guide, I am not convinced the basic issues have much changed.

As I understand it, the concept that regional trade agreements might act as 'building blocks' for multilateral trade liberalisation comes originally out of game theory and the theory of the second best. Simply stated, the political economy idea was that the pace by which any Governments could bring their communities along with trade liberalisation is a critical factor in what is disparagingly called 'the real world'.

Certainly, multilateral liberalisation is the first best option. But it may well be easier to negotiate with a set of countries rather smaller in number than the universe of all countries - or, practically speaking, all Contracting Parties to the GATT or today, the 130-plus WTO Members. That is strengthened further if one considers that in most cases such a process would take place among contiguous countries whose cost structures were more likely not to be sharply different, implying a lesser degree of economic adjustment to bilateral liberalisation.

That, by the way, was absolutely central to selling CER to a NZ community in the early 1980s, deeply addicted to protectionism - because of a very human fear of being unable to compete. We had the OECD world's last remaining system of comprehensive import licensing (Australia had abandoned its system

in 1960s, but for a few pockets). Back then, people like me working in the Treasury and Foreign Ministry could never sell the idea of global removal of import licensing, but we finally could sell exempting one country - Australia. More on that later.

Further, since the process of trade liberalisation requires political sustenance from whatever corner it can acquire political sustenance, regional trade agreements usually have an overt political character from which they gather support. The clearest expression of that was of course the formation of the EC by six European countries, based around the very reasonable political proposition that 3 Franco-Prussian wars since 1870 - one of which developed into a catastrophic European war, with kind assistance from the Antipodes, and the last into a World War - all this was three Franco-Prussian wars too many.

But the theory of the second-best approach to trade liberalisation was always deeply controversial within the economics profession. I will not go into the old technical literature here, but mention two obvious and legitimate concerns: trade diversion and what is usually called the 'Fortress Europe' dilemma - that is, the real danger that in creating an economic interest for those inside regional trading agreements you create resistance to eroding it through multilateral trade liberalisation.

These concerns about regional trading agreements were not merely theoretical concerns confined to the academic literature. First, trade diversion costs were a genuine concern for serious policy makers who understand that trade policy is not a diplomatic game. If you formed preferential agreements, driving down to zero tariffs without import licensing systems under whatever guise (ie all those measures captured by the GATT jurisprudence around Article XI:2 (c) - I thought I would throw that in for trade policy connoisseurs) while your MFN regime was configured around high tariffs and NTBs, you could be imposing considerable foreign exchange costs on your economy.

In extremis, this could even lead to the phenomenon of perverse resource allocation. However, this is an after dinner speech and a nice little dissertation on perverse resource allocation in this setting may indeed be considered perverse.

I will come back to this issue momentarily. It is sufficient to note here that this issue is an **implied quantitative matter**. That is, to note that there may be trade diversion costs associated with regional trade agreements and stop there is to say something of little consequence.

The real issues are (a) how much?; and (b) for how long do we bear these implied foreign exchange costs by entering into a regional trading arrangement with a country or countries that may not be the most efficient source of imports in many areas?

The answers to both depend upon trends in the frontier protection regime applying on an MFN basis.

Let's not get too technical. The much more basic concern for multilateralists like me and virtually every Australian and NZ member of our trade policy communities is: will they act as a barrier to multilateral trade liberalisation? Will it prove so comfortable within the fortress that there will be no constituency for venturing outside?

Back to 1980: A Thought Experiment:

Now turn to the empirical evidence on that matter. Let me give you, *a la* Mansur Olsen, a simple thought experiment. Imagine it is 1980 and we are all policy advisers in either Australia or NZ. We are asked by our Ministers the following question: 'What, in your opinion, would be the greatest threat to progress in the already highly imperfect GATT system?'. My supposition is that we would have responded with one voice: "the proliferation, Ministers, of bilateralism would be the greatest threat to multilateralism".

That would have been a very respectable and defensible response. Putting aside the quite powerful academic critique of regional trade agreements, the facts would be staring at us in the face - more so in Australia and NZ than any countries, with the possible exception of the Southern Cone economies of Chile, Argentina, Brazil and Uruguay - the embryo of one of Australia's finest diplomatic achievements, the formation of the Cairns Group.

What was reality in 1980? We had dreadful regional trading agreements to test reality against The Theory. We had between us, the deeply interventionist and hopelessly flawed NAFTA - the NZ Australia Free Trade Agreement. A FTA in name only. We had Ministerial meetings held literally to decide the number of peas and beans we could sell to each other. We had an obscure provision called Article 3:7 so we could swap, in the immortal phrase, 'pantyhose for Holdens'. It was the Politbureau on an off day.

Much more dominant in our thinking was the EU. OK - we know better than any countries about the Franco Prussian wars. One of them wiped out a large part of a generation of young Australian and NZ males. But the economic policy instrument chosen to cement Europe was a nightmare - the CAP, or Common Agricultural Policy. For a generation Australian and New Zealand trade negotiators were told that nothing could be done to touch the CAP - it was the cement that held the European experiment together. In a sense it was: typically 70% of EC expenditure was on agriculture subsidies.

The cost on our economies was enormous - even more so for NZ than Australia, given export structures at the time. That is why NZ benefited more from the Uruguay Round outcome than any country in the world. It was simply the flip side of the costs we had borne as European protectionism - the direct consequence of regionalism - ground us first out of Europe and, as we sought to diversify into Asia and beyond, pursued us in these third markets with their export subsidies, delicately called 'export restitutions'. There is one thing that all apparatchiks, in whatever country, have in common - a genius for disguising malignant policy with euphemism.

Finally, these regional trade agreements - basically EFTA and the EC - were a fundamental obstacle to making progress with each multilateral trade round. Under the surface of each of them was one fundamental and unresolved question: was the world going to accommodate itself to the CAP by devising permissive trade rules for the CAP policy instruments? Or was the CAP going to accommodate itself to the world? The Kennedy Round and the Tokyo Round delivered no answer, but that was better than a bad one. The Uruguay Round answered it decisively: the CAP was adjusted to the world. The first steps are limited in commercial terms and that is why farmers in our two countries do not really understand the enormity of the shift.

So little wonder that Australian and NZ policy makers had such a jaundiced view of bilateralism - or regional trade agreements, if you wish to be formal.

However, the art of sound policy is to revisit it from time to time and see if the world has shifted - if contextually, the policy needs adjusting.

The Trade Policy Landscape Today:

Now flick from 1980 to the present. I want to step right back from detail and look at three broad issues: the shape of multilateralism, the evolution of bilateral or regional trade agreements and some broad, certainly contestable, comments about Europe today compared with pre-Uruguay Round Europe. So, from those perspectives, what does the world look like?

What is undisputable is the following:

- First, the multilateral system - after perhaps the most severe test to its relevancy it ever faced in the early 1980s - has been greatly strengthened systemically.

Among what we call the 'old issues', three issues of strategic significance to world trade which had remained effectively outside the framework of rules for decades: agriculture, textiles and the grey area have been brought within the framework.

In certain areas, the modalities for doing so are subject to just and serious criticism: in agriculture, for example, the very weak disciplines over internal subsidies; in textiles, the extent of backloading in the adjustment process. These deficiencies arose, of course, from the dynamics and realities of the negotiating process, not the ignorance of the negotiators. But that cannot obscure the fact that what had remained in the GATT 'too hard' basket for multilateral round after multilateral round was finally dealt with and in the case of agriculture, decisively so.

In the so-called 'new areas', a framework for dealing with services, intellectual property and a weak framework for trade-related investment measures were put in place. These are major political achievements, with significant commercial consequences - I am dealing with one of them right now as a WTO panellist on the US/Canada autopact.

There was a major strengthening of the WTO dispute settlement process - an audacious limitation of sovereignty: ask Australian leather exporters. But even if it is extremely difficult for losing parties to comply with legal rulings, at the end of the day we in Australia and NZ know that our historic problem was precisely that other larger countries had too much sovereignty over our economic welfare. We are about to test this in the pending WTO sheepmeats case.

Finally, of course, the expansion of membership in which the last two historic steps are before us: China and Russia. While this makes political management far more difficult and messy - it is always easier to run a cosy club - that is to look at the WTO through the wrong end of the political and historical telescope.

So it is clear that since our 1980 'thought experiment', as it were, and even acknowledging all the many difficulties we face defining the mandate, scope, timetable and modalities for Seattle, the multilateral trading system is far stronger than it was as we teetered into the abyss of the Uruguay Round negotiations.

- Fact two in our survey of the current landscape: there has been a vast proliferation of regional trading agreements - one estimate is that there are now 220. As a result of what happened in Auckland, we are going to add to that number. Recall here that our earlier 1980 thinking was that the expansion of 'bilateralism' (or regional trade agreement) would normally have been identified as inimical to progress on the multilateral front. To me it is crystal clear that was the wrong judgment, even if it is a judgment I would have shared 20 years ago, for all the reasons I earlier sketched. What we find is that the two have gone hand in hand.

While analysts, including myself, are incapable of comprehending the structure of all or even most of these 220-odd RTAs, the ones I look at are much less malign than these older paradigms.

I have many negative comments I could make about NAFTA, mark II - ie the North American Free Trade Area: its excessively litigious approach, its strange rules of origin designed to take back with one hand what overt trade liberalisation delivers with the other. So it is not a perfect world. What's new? But the charge of 'Fortress North America' simply does not stick.

The Canadians have problems with multilateral trade liberalisation - they have a completely bifurcated approach to agriculture liberalisation which has yet to be adjusted to the reality of the Uruguay Round: it is free trade where we, Canada, are strong, supply management and strong resistance from Canada to trade liberalisation where Canada has begun no serious adjustment to the reality of globalisation of agriculture. I know there are Canadians who are trying to change that. Could you please hurry up.

The US has its problems, which everyone in this audience knows about but which I believe it is seeking to manage as best as it can, given current political structures.

But whatever difficulties exist with advancing the first-best cause of multilateral trade liberalisation, no-one in North America is arguing against multilateral trade liberalisation because they wish to preserve the preferential position they enjoy through their regional trade agreement.

Consider also our experience with CER. This agreement allowed one small and deeply defensive country - NZ - to escape the trap of protectionism. It set in train a process of progressive liberalisation of our frontier that now sees us at the very forefront of trade liberalisation.

- Finally, consider Europe today. Europe is immensely important to the multilateral trading system. It has one third of world trade. Today, the EU has replaced the EC. It is more than a change of name. The European experiment has moved way beyond a regional agreement based overwhelmingly on an obsession with agriculture subsidies. It has moved with astonishing speed. The Single Market, Maastricht, the replacement of some of the greatest currencies in history - the Deutchmark, the Franc, the Lira - with the Euro. Give credit where credit is due.

I know we shall have a struggle in the Next Round advancing with the agenda for further liberalisation of agriculture. Nothing in history, I suppose, should ever be called 'inexorable'. The apparatchiks in departments of agriculture all over Europe, in Canada Agriculture and many corners of USDA are still plodding away with their input-output models and supply./demand forecasts,

trying to plan the unplannable in otherwise free enterprise economies - but much less so, one must emphasise, in the US in the wake of the 1996 Farm Act.

There is a wonderful Bertolt Brecht limerick that often came to mind when I was Chairman of a dreadful organisation, now thankfully defunct in the wake of direct disciplines over export subsidies. It was called the GATT International Dairy Council or as one very smart Frenchman put (I shall translate): "Europe's little OPEC with NZ". As I watched and listened to them, Brecht's immortal words came to mind:

*"Saw civil servants, green with mildew.
Keeping their huge manure contraption on the move.
So badly paid for all their bullying and creeping;
I only hope their salaries improve".*

The only problem was that, as far as I could make out, they were rather well paid for their 'bullying and creeping' and, as Chairman, I knew that I would never get a decision until day 2 of the meeting so that they could collect another set of *per diems* before returning to capitals. I learned as a young man working for the extraordinary Prime Minister Muldoon, 'never underestimate human nature'.

The apparatchiks are still there. There will be another titanic attempt on their part to fight the lost fight again. 'Agriculture specificity' now has a new name - 'multifunctionality' - it is exactly the same concept, engineered for the same agriculture ideological battle because the Cairns Group kept its maiden name (agriculture specificity) out of all negotiating documents. So we shall have to engage, but we and the US will win.

At least this time our negotiators will not have to fight the essential philosophical question - is agriculture 'in' or 'out' of the Single Undertaking? Nor will we have to design from scratch the modalities of bringing a huge number of disparate agricultural policy instruments within one negotiable frame. There will be further useful progress towards the objectives of the Agriculture Agreement. I am happy to take any bet with anyone on this. The only thing I am not betting on is 'when' or the extent of that progress - but I bet it will not be derisory.

To me, looking at the forest, not the trees, it is of the utmost importance to understand that the Europe of 2000 is a far larger and more impressive concept than the Europe we confronted in the mid 1980s, bound together only by a shonky and unsustainable system of agriculture subsidies.

NZ Policy on Regional Trade Agreements:

So the conclusion we have drawn from looking at the world in the 1990s and trying to formulate NZ policy on regional trading agreements is a quite simple one.

We know, better than any country, about the malignant model from our historic (and ultimately successful) fight to engage with the CAP over 20 years through Protocol 18 of the UK accession to the EC, which contained special provisions for NZ, whose economy would have been destroyed without them. We know too - from CER - the benign model of regionalism - the 'building block' model.

So it seems to us rather clear: to have a general policy that says either 'bilateralism bad' or 'bilateralism good' is a nonsense. It depends on their technical construction, which in turn is driven by their philosophy.

If the philosophy driving the construction of regional trading agreements is that of trying to move ahead of what the multilateral traffic will bear, of trying to chart out new directions totally consistent with the underlying objectives of the WTO and APEC - why not? If they are not - the agreements are not comprehensive or, far worse still, have a political or contractual commitment to maintain a margin of preference - then we are completely opposed to such regional trading agreements.

Finally, let us return to the more austere question of trade diversion. Recall my observation that at heart the issue is not whether there is trade diversion. Rather, the matter is an implied quantitative one: how much trade diversion is there in any given regional trade agreement? and for how long do we have to impose these costs on our economy by entering into an agreement with a country that may not be the most efficient source of at least some imports?

That, in the world of the late 1990s, is barely an issue except - paradoxically - in agriculture. It was a huge issue four decades ago for would-be negotiators of bilateral or regional agreements when industrial tariffs average 50%.

You create a price wedge between an MFN tariff of 50% and a preferential tariff of zero and you create a massive incentive to source imports from your regional trading partner. Now, average industrial tariffs are less than 5% - and yes, I have heard of tariff peaks.

The problem of trade diversion is still there, but it was always an implied quantitative problem and it is now small and getting smaller. At the end of the day, the complete answer to trade diversion for any member of a regional trading agreement is in their own hands: eliminate your MFN frontier protection. That is exactly what we shall have done by 2006. We might have suffered trade diversion by entering into CER and creating an incentive to source imports

inefficiently from Australia. The concern today is very small and about to become irrelevant.

For this reason, NZ trade policy has been saying since 1993 that we are ready to sit down with any of our regional trading partners to explore the possibility of a FTA, provided it was based on a set of clearly articulated principles among which the principle of comprehensive liberalisation is the most critical.

It has been a policy that is easily stated, but difficult to implement. It has been difficult to implement for three, stunningly obvious reasons:

- we are a small economy - about one seventh the size of the Australian economy or the Korean economy - so we lack critical mass;
- we are already an open economy so if potential dancing partners have a streak of mercantilism in their make up (and most do), there is not much to gain in terms of improved access to our market.
- Finally, we have deliberately set the bar high - comprehensive liberalisation: no exceptions for sensitive products. Time to adjust to that is not an issue.

Some elaboration on this last point may be in order. We have said that if any country were interested, and they have difficult adjustment difficulties, we have said essentially 'how much time do you need?' To have a policy which twinned the principle of comprehensive liberalisation with an obsession with rapid progress would be to live in a technicolour dreamworld. In my experience, political realities always bear down on every trade negotiation. Better to accommodate political difficulties through very generous time provisions than go for quick and dirty results.

This of course is an expression of our experience with CER. Your negotiators realised that NZ needed the comfort of a vastly extended phase-in to comprehensive liberalisation. The original CER formula inside the Treaty envisaged elimination of all remaining import licensing by 1995. But the political economy reality is different: when our defensive manufacturers realised that sooner or later they had to face the appalling prospect of having to compete with Australia and they faced the reality of slow but explicit programme of liberalisation, they made the adjustment way ahead of schedule. They stopped lobbying for protection and started to become efficient. Then they came to the Government and said: 'Look, just get rid of this barrier to trans-Tasman commercial integration now'. So we did: an adjustment path of 13 years was collapsed into 5 and everyone was happy.

The lesson for us is clear: set out a slow but explicit formula and the formula, for political economy reasons, will have an in-built tendency to implode. And if it

did not implode - ie progressive liberalisation caused serious adjustment problems - then politically the other country would probably need more time. In most cases they will not, because the evidence is clear: trade liberalisation is accommodated with far less angst than those who bitterly oppose it imagine.

But we have, as I said, had difficulty finding dancing partners. We have had a couple of false starts - I won't go into those. There have been those in NZ who were impatient with our policy - they thought it was too rigid. My response is simple: we are not interested in accumulating FTAs as political trophies. It is not a diplomatic game. It took Australian and NZ negotiators four decades to achieve one strategic objective - integrating agriculture into the GATT rules on a sound basis. For those who wish to dabble in trade policy and are personally inclined to instant gratification, I always suggest they should seek their *metier* elsewhere.

But last week in Auckland we appeared to have moved forward, though the results have been totally buried in NZ by the combination of APEC's main formal agenda, East Timor and the bilateral visits after APEC of no less than three Presidents - the Presidents of China, Korea and the United States.

The reason why we have moved forward is because of a particular strategic view starting to coalesce around the Bogor Goals of free and open trade in the APEC region by 2010/2020. That view - and it has been a controversial one - is that if we are to reach those Goals, we need to deal with the Free Rider problem.

The Free Rider problem is not a problem for NZ. How could it be? We have just unilaterally liberalised our frontier regime. But if the lack of reciprocity involved in the 'concerted unilateral' model is a problem for certain major APEC economies - and it manifestly is - then it is a problem for APEC and a problem we, as one APEC economy, have to face.

One way to solve it would have been to seek to multilateralise the Bogor Goals and pass the issue to the WTO. In the WTO, given the negotiating process and the Single Undertaking (by whatever name), the free rider problem is contained. But that has yet to happen. Some commentators have then asked the question - what would that leave APEC to do? Actually, that is a misunderstanding of the evolution of APEC which is far broader than merely a vehicle for trade liberalisation - but to go into that is to enter into another speech.

In any event, time is pressing. There are only some 10 years left to achieve the Goal of free and open trade amongst the developed APEC economies. There is, to put it mildly, much to be done.

We are well aware that some - there may be some in Australia, for all I know - who believe we have already slipped into dangerous territory, when one considers the dimension of the challenge and the time available to confront it.

We have not reached that conclusion. We know that Bogor merely defined an objective and was not prescriptive on how we were to get there. So we are trying to define part, not the whole, of the path.

One thing is clear: there is no Free Rider problem in a FTA. And if a sub-APEC FTA is based on sound principles and is fashioned explicitly with the Bogor Goals in mind - why not? As long as participants share a vision of open membership, the terms of which need to be negotiated to take account of adjustment difficulties.

So this week in Auckland we have done the following:

- The Prime Ministers of NZ and Singapore have committed to negotiating a bilateral 'state of the art' FTA, based explicitly on the Bogor Goals. It is limited, of course, in its commercial consequences but we are very pleased that the Government of Singapore has committed to full liberalisation, on a bilateral basis, of its services regime by 2010. For those who are interested in a more elaborated explanation of its strategic underpinning, you could read the joint article by our two Prime Ministers in the *International Herald Tribune* of Tuesday 14 September.

What we are trying to do here, apart from achieving some modest gains commercially, is to build a bridge between two existing sub-APEC FTAs: CER and AFTA, but if other APEC economies saw merit in participation we would welcome it.

We thought this initiative might have some catalytic effect. It already has:

- When the Chileans were informed of this development, we quickly reached agreement to study a FTA amongst our three economies. We are finalising the Terms of Reference for that Study right now and you would not want to pay for my Melbourne hotel telephone bill as a consequence. Political developments will determine what happens, but in our view, this is a step towards such a FTA based on APEC and WTO plus principles. It is not necessarily the final configuration.
- We have reached an agreement with Korea for a study of a NZ/Korea FTA. That is one step removed from Government - it will be conducted by KIEP and the NZIER, research organisations close to policy makers.

- But our modest efforts are not alone. Korea and Chile have agreed, at Head of Government level, to negotiate a FTA. This is a very significant policy shift by Korea. It is potentially commercially significant to us - Korea is our fifth largest export market. Chile is a competitor and the second most important country to NZ, after Australia, as a destination for our own outward foreign investment. I believe we are the third or fourth largest foreign investor in Chile.
- Mexico and Singapore have agreed to study a FTA. This is potentially another bridge between two sub-APEC FTAs: the NAFTA and AFTA.

Does this proliferation add up to chaos? Not at all, because of the APEC-friendly and WTO-friendly philosophy driving these APEC economies and their approach to regional economic integration in the APEC region. Some want to go faster towards Bogor than others. Obviously, one caveat: the Korean approach will need to be considered carefully because it is new territory for them. One of the purposes of our 3-way study with Chile is to keep very close to them as they negotiate their bilateral FTA. I have to say having worked with Chileans for years, I have great confidence and respect for them. They are smart people. The same consideration was also, of course, in our minds, when we negotiated with the Korea the idea of a 'study' of a Korea/NZ FTA.

For all of these economies the multilateral trading system is far, far more important than any FTA but, like us, they appear to have decided that they can, in trade policy terms, walk and chew gum at the same time provided these different instruments of liberalisation are based on consistent philosophies.

These means that virtually all APEC economies are now members of FTAs or, in the case of Korea, negotiating one. Only the three Chinas and Japan have no FTAs.

The challenge now is to deliver high quality bridging mechanisms so we can drive decisively towards the Bogor Goals. I wonder what the trade policy strategists in Tokyo are thinking about?

Thank you.