



# Alerts on Emerging Policy Challenges

## PREFERENTIAL TRADE AGREEMENTS: AN INSURANCE AGAINST PROTECTIONISM?

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### Introduction

Faced with a global recession, policymakers around the world are currently considering measures to help their national economies recover from the impact of the financial crisis. Several countries have adopted fiscal stimulus packages that support selected industries, including the car industry and financial sector.<sup>1</sup> Other countries have announced tariff increases and/or new or more restrictive non-tariff barriers such as licensing requirements or subsidies.<sup>2</sup> While governments immediately defend their own policies as complying with international trade obligations, they are almost equally quick in threatening retaliation or litigation under World Trade Organization (WTO) rules with respect to other countries' protectionist moves.

While history teaches that a global return to protectionism would be harmful to all economies, even a partial increase in use of protectionist trade policies is likely to have a severe impact on the Asia-Pacific region,

whose recent growth was largely based on exports.<sup>3</sup> Indeed, much of the current manufacturing production of larger Asian exporters cannot easily be redirected to, or absorbed by, home markets. China in particular, as the region's leading exporter, will likely suffer severe losses as a result of shrinking trade in 2009.<sup>4</sup> Such losses will be exacerbated by foreign markets becoming less open as a result of protectionist policies.

The financial crisis and ensuing recession has ignited a world-wide debate as to the need for, and danger resulting from, measures enacted to protect national markets. This note will examine provisions of WTO agreements and common preferential trade agreements (PTAs) relevant to the spread of (new) protectionism. We argue that policymakers in the Asia-Pacific region may have less space for protectionist policies than they may wish due to the binding nature of their PTA commitments. Moreover, this note will argue that in circumstances of severe economic turmoil such as the current crisis, PTAs could better serve as shields

<sup>1</sup> For example, the Governments of the United States of America, the United Kingdom, Japan, Australia, China and Thailand have each announced bail-out and/or stimulus packages in recent months.

<sup>2</sup> For example, Indonesia has designated only five ports and certain airports to serve as entry points for certain sensitive imports such as electronics, garments, toys and food (ITC Business Briefing-Trade Policy, 9 February 2009); India has enacted a six-month ban on Chinese toy imports citing safety concerns (WTO Trade News, 9 February 2009); the European Commission reintroduced subsidies for butter, cheese and milk powder as of January 2009 (WTO Trade News, 16 January 2009).

<sup>3</sup> Best illustrated by Kindleberger's downward trade spiral resulting from the U.S. Smoot-Hawley Tariff Act of 1930 (Kindleberger, 1986).

<sup>4</sup> China's exports dropped 17.5 percent and imports plunged 43 percent in January 2009 from the same month a year earlier; this is a continuation of the contraction of exports and imports already registered during the last quarter of 2008 (see more details in ESCAP 2009, forthcoming).

against protectionist practices if they included government procurement liberalization disciplines or if countries were signatories of the WTO's Government Procurement Agreement (GPA).

## Can WTO rules prevent a surge in protectionism?

### **WTO disciplines apply even in a financial crisis**

An initial question for WTO member countries is whether the current financial crisis may justify them in rescinding or amending their obligations under WTO multilateral trade agreements. Under both the General Agreement on Tariffs and Trade (GATT, 1994)<sup>5</sup> and the General Agreement on Tariffs and Services (GATS), the answer is straightforward: countries may modify or withdraw their commitments only after providing advance notice, consulting affected trade partners, and negotiating compensatory adjustments with them.<sup>6</sup> This procedure is too cumbersome to be useful as a tool to mitigate the effects of the financial crisis, and adds a financial burden, as countries must compensate for any measures that may adversely affect trade partners.

Beyond this rule, the WTO disciplines admit only a narrow list of reasons for which member states may unilaterally suspend their obligations. These reasons include public health and safety, as well as essential security interests.<sup>7</sup> In addition, countries experiencing “*serious balance of payments and external financial difficulties, or threat thereof*”<sup>8</sup> may adopt restrictions on trade. Finally, with respect to trade of goods only,<sup>9</sup> countries may take temporary emergency action on imports of particular products to provide protection against sudden injurious import surges.

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<sup>5</sup> The text of all WTO agreements, including the GATT 1994 and GATS are available at [www.wto.org](http://www.wto.org).

<sup>6</sup> Article XXVIII GATT and Understanding on the Interpretation of Article XXVIII of the GATT 1994, and Article XXI GATS.

<sup>7</sup> GATT Articles XX and XXI; GATS Articles XII to XIV bis.

<sup>8</sup> Understanding on the Balance-of-Payments Provisions of the GATT (1994), GATS Article XII.

<sup>9</sup> GATT Article XIX.

None of these exceptions apply to the current circumstances of most Asian economies. While some developed economies may be running trade deficits, for the most part, their balances of payments remain healthy. Similarly, for most developing economies in the Asia-Pacific region the balance of payments is not under threat, particularly if currencies are allowed to adjust in response to market conditions. As a result, Governments must continue to comply with their obligations under the WTO agreements to avoid being dragged into the dispute process or suffer retaliatory protectionist measures. This outcome makes good policy sense, as the aim of multilateral trade agreements is to safeguard liberalization especially in times of economic crisis, when countries' self-preservation instincts and popular pressure suggest a protectionist course.

### **Most countries retain flexibility to increase tariffs under GATT rules**

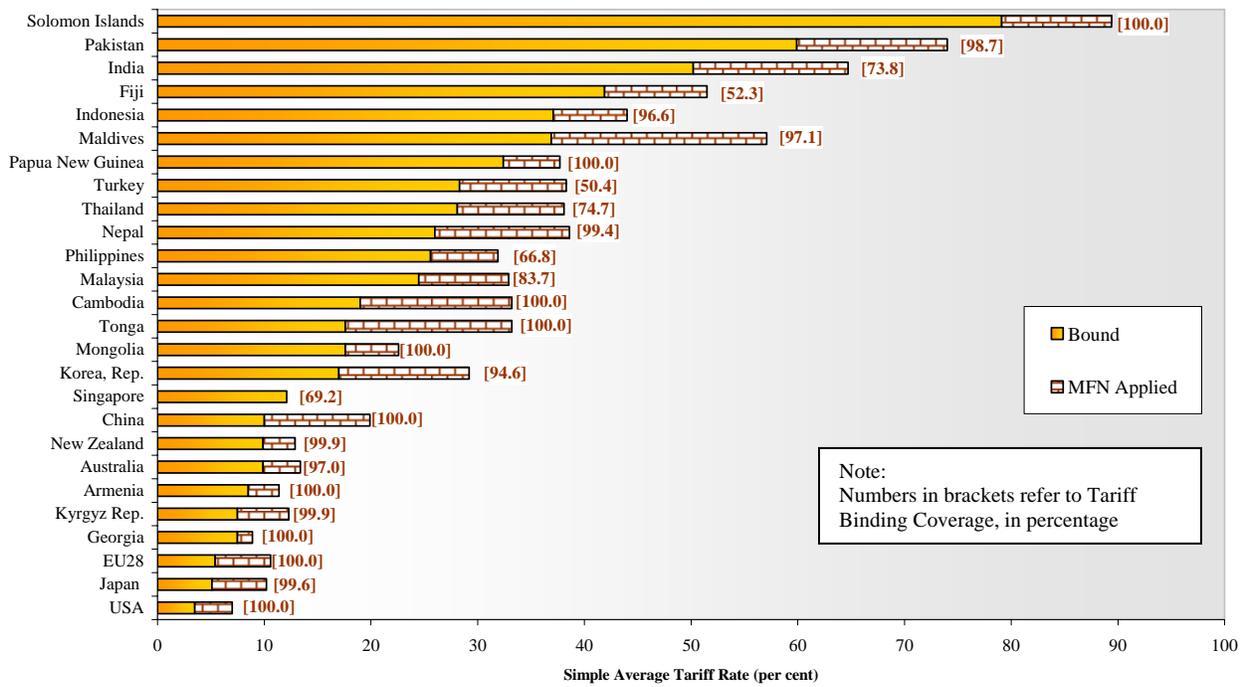
Notwithstanding the above, under current GATT rules, many countries have flexibility to unilaterally increase their tariffs. Indeed, under Article II:1(b) GATT (1994), each WTO member has committed not to impose tariffs which are “*in excess of those set forth*” in its schedule, also known as the “bound rate.” Under WTO rules, countries with applied rates below their bindings thus retain the flexibility to unilaterally increase their tariffs up to the bound rate, without being required to provide any justification or compensation.

In practice, many countries apply tariffs well below the bound rate. Indeed, for the developing countries of the region of the United Nations Economic and Social Commission for Asia and the Pacific (ESCAP), taken as a whole, there is an average difference of 23 percentage points between their applied and bound rates (see Figure 1).<sup>10</sup> Furthermore, the spread between bound and actual tariff rates differs widely across subregions of ESCAP: the differences range from 53 percentage points for South Asia, 32 for the Pacific region, and 8 for Central Asia, to just above 5 percentage points for East and Northeast Asia (see Figure 2).

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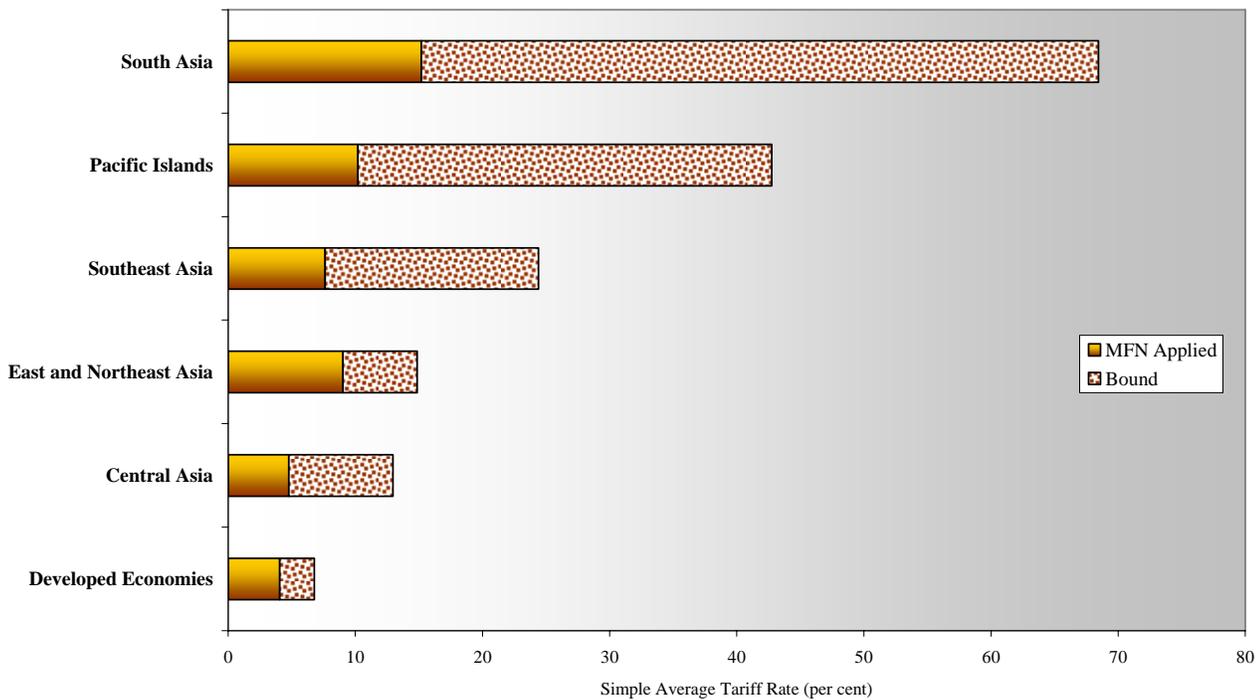
<sup>10</sup> The data is available only for the 21 developing countries who are members of both the WTO and ESCAP.

**Figure 1**  
**Difference Between Applied and Bound Tariff Rates**



\*Tariff rates are for 2008, source: WTO Profiles 2008 available at <http://www.wto.org>

**Figure 2**  
**Difference Between Applied and Bound Tariff Rates - Sub-regional Averages**



\*Tariff rates are for 2008, source: WTO Profiles 2008 available at <http://www.wto.org>

By contrast, developed countries of ESCAP on average allow for a less than 3 point spread between applied and bound tariff rates. Only very few countries, such as China and Tonga, apply tariff rates equal to or nearly equal to their bound level, and would therefore have no flexibility to increase their tariffs, except through recourse to the escape provisions mentioned above.

In addition, under current WTO rules, not all imports are subject to bound tariff rates. While most developed countries now bind rates on almost 100% of tariff lines, many Asia-Pacific economies' percentage of coverage is significantly lower. For example, as shown in Figure 1, China, Mongolia, Solomon Islands, Tonga and several other countries committed to binding 100 percent of tariff lines, whereas Fiji's commitments cover only 52 percent, Turkey's 50 percent and Singapore's 69 percent of tariff lines.<sup>11</sup>

In conclusion, if applying only WTO (GATT) rules on tariffs, many Asia-Pacific countries would have some policy space to increase their tariffs to protect their markets without violating international trade agreements. The same cannot be said, however, when applying preferential trade agreements.

### **Can preferential trade agreements prevent a surge in protectionism?**

As recorded in the ESCAP's Asia-Pacific Trade and Investment Agreements Database (APTIAD),<sup>12</sup> there has been a proliferation of PTAs in the Asia-Pacific region in the past 15 years. While not all agreements are active or even fully in force, some have significantly or fully liberalized trade among their parties. They therefore need to be examined in order to determine their impact on policymaking space in the current economic crisis.

Most of the PTAs in the Asia-Pacific region provide for a gradual elimination of all tariffs over a 10 or 15 year time period. These agreements also categorically prohibit any unilateral increase in tariffs, and, somewhat

less categorically, an increase in non-tariff measures. In addition, the exceptions included in these agreements tend to be limited to the same exclusions already mentioned for the WTO – security, health, and balance of payments. Finally, most PTAs can be rescinded entirely only with a six-month or year-long notice period, and unilateral amendments require compensation. As a result, under most PTAs, countries have neither the policy space to amend their obligations, nor do they have the flexibility to increase either tariffs or most non-tariff measures.

Estimates of the share of goods (and services) traded under PTAs (as compared to under the Most Favored Nation (MFN) multilateral rule) vary greatly and often depend on the meaning given to the terms “traded under preferential treatment” or “traded under PTA”. If the share traded under PTA is calculated simply as the proportion of trade among partners that have signed trade agreements as compared to their total trade, then such share is guesstimated at around 40 to 50 percent for the world as a whole. As illustrated in Figure 3, for countries in the Asia-Pacific region, estimates range from over 40 percent in the Philippines and Thailand to 80 percent in Brunei Darussalam.

By contrast, if the share of goods traded under PTA is defined as the utilization rate of preferences negotiated under the PTA, then the estimates are much lower both for the global economy and the Asia-Pacific region. Medvedev (2006) estimated that an overwhelming majority of goods and services were traded worldwide under the MFN provisions of the WTO Agreements, while as little as 10 percent of goods and services were traded under PTA concessions.<sup>13</sup> However, utilization levels of PTA preferences are deemed to be higher in the Asia-Pacific region, reaching about 25 percent for members of the Association of Southeast Asian Nations (ASEAN), 35 percent for the Asia-Pacific Trade Agreement (APTA) and 15 to 20 percent for the South Asian Free Trade Area (SAFTA).

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<sup>11</sup> WTO Tariff Profiles. [www.wto.org](http://www.wto.org)

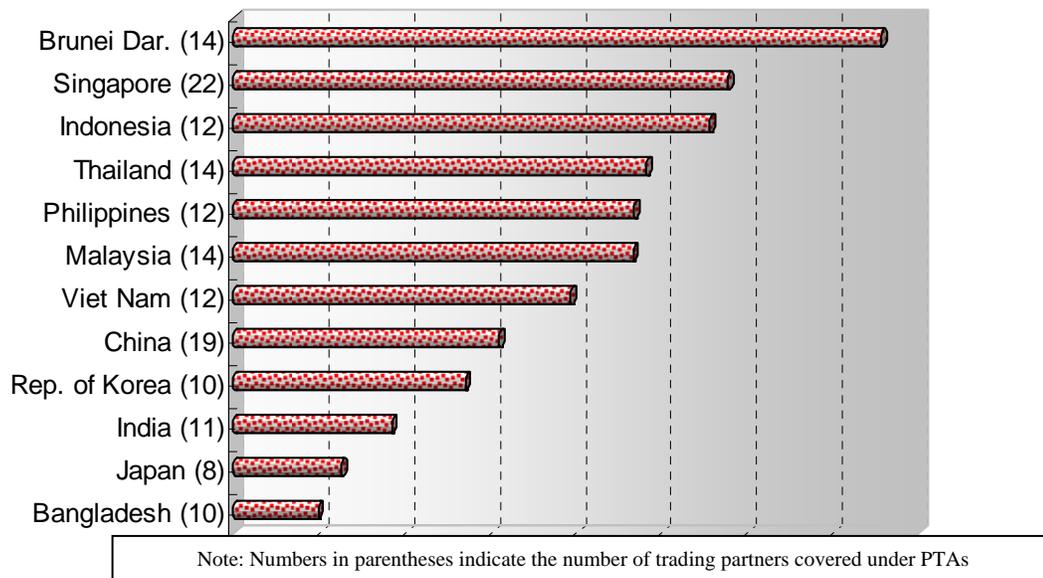
<sup>12</sup> Available at <http://www.unescap.org/tid/aptiad/>.

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<sup>13</sup> Medvedev (2006)

**Figure 3**

**Trade with Partners in PTAs 2006 (% of total export)**



The most frequently cited reason for low utilization rates of PTA preferential concessions is the high cost of compliance with the rules of origin. Such compliance costs often exceed any savings to be made as a result of the margin of preference (i.e. the difference between the MFN tariff rate and the preferential tariff rate). As countries threaten to raise their MFN tariff rates under multilateral trade agreements to respond to the crisis, there is a possibility that margins of preference under PTAs will become more attractive in the near future, and more traders may start utilizing these preferences. In this case, PTAs may well boost trade among their members as lowered trading costs are especially crucial when demand for exports is insufficient.

In conclusion, it would appear that most countries in the Asia-Pacific region have little policy space to raise tariffs in trade with their PTA partners. Overall, this should be considered a blessing, as all countries stand to lose from escalating tariffs, while all stand to gain from liberalized trade.

Of course, the real protectionist threat comes from the risk of increased non-tariff barriers. This holds true especially in connection with recovery and bail-out packages which will likely be more (if not solely) tailored to national producers, service providers and the domestic labor force.

Even if this intention is not explicitly stated as part of legislation introducing such packages, the implementation guidelines issued by governments will likely carry a hint of such an intent.<sup>14</sup> While the national treatment principle under multilateral trade agreements might provide some buffer, it appears that countries would have a better insurance against protectionism if they were to enter into agreements liberalizing government procurement, either at a plurilateral or bilateral level.

**Liberalization of government procurement rules**

With the world's economies in a downward spiral and commercial ventures contracting,

<sup>14</sup> WTO Trade News, 18 February 2009.

markets in 2009 depend heavily on public spending. Indeed, many countries have already adopted, or are in the process of adopting, fiscal packages to create employment and stimulate national industries. Against this backdrop, the government procurement rules in international trade agreements take on a heightened significance.

A total of 39 countries have signed the Government Procurement Agreement (GPA, 1996)<sup>15</sup> negotiated in the framework of the WTO. While the United States, the European Communities and Canada have ratified the agreement, among others, only four economies in the Asia-Pacific region have done so to date (Japan, Republic of Korea, Singapore and Hong Kong, China). The GPA liberalizes government procurement rules across borders to allow companies to bid in each others' public tenders and benefit from non-discriminatory treatment.

For example, the United States US\$ 787 billion stimulus plan signed into law on 17 February 2009 requires all projects financed under the law to use only US-produced iron, steel and manufactured goods. However, the law also stipulates that this rule "*shall be applied in a manner consistent with United States obligations under international agreements.*"<sup>16</sup> As a result, products of countries who have entered into either the GPA or bilateral agreements liberalizing government procurement with the United States will be eligible for bidding under these projects.

A review of PTAs reveals that most agreements in the Asia-Pacific region expressly exclude government procurement from their scope. In a few cases, provisions on government procurement are included, but only serve to reaffirm a general commitment to transparency, open and effective competition, due process and non-discrimination in government procurement procedures.<sup>17</sup>

On the other hand, countries that have already ratified the GPA tend to include expansive

provisions in their bilateral agreements incorporating those rules (see for example the PTAs between Republic of Korea and Singapore, Japan and Singapore or Singapore and the United States). Such countries tend to demand comprehensive government procurement provisions when entering into PTAs with countries that are not members of the GPA (see for example the PTAs between Singapore and Panama, Japan and Mexico, Australia and the United States, the Republic of Korea and Chile, Australia and Singapore or New Zealand and Singapore).

Governments of developing countries especially have historically argued that their public contracts must be awarded exclusively to national companies in order to protect national industries and jobs. However, the reverse argument can be made: open, transparent and non-discriminatory procurement can increase value for money for governments by optimizing competition among suppliers. National suppliers who have to compete with international suppliers are likely to optimize their processes and products to remain competitive. In addition, international procurement can help keep at bay the influence of corruption and political favoritism.

In the long run, economies would thus have much to gain from liberalizing their government procurement rules. Such policies are also a good insurance policy against challenging economic times such as the present ones, when most new contracts are in the form of public tenders open only to national companies and selected preferential trade partners.<sup>18</sup>

## Conclusion

Preferential trade agreements, long criticized as being obstacles to multilateral trade liberalization, may yet prove their value in the

<sup>15</sup> Details are available at [http://www.wto.org/english/tratop\\_e/gproc\\_e/memobs\\_e.htm](http://www.wto.org/english/tratop_e/gproc_e/memobs_e.htm).

<sup>16</sup> American Recovery and Reinvestment Act of 2009, Section 1605 (a) and (d), available at <http://www.whitehouse.gov>.

<sup>17</sup> See for example the agreements between New Zealand and Thailand, Australia and Thailand, Japan and the Philippines. See more in APTIAD. See also Anderson and Mueller (2009).

<sup>18</sup> One may argue that instead on relying on GPAs, governments could impose certain conditions to their public bids referring to, for example, domestic employment, while still allowing access of foreign companies to tenders. This is akin to domestic content requirements and may therefore be in violation of other WTO rules in addition of being difficult to enforce. Moreover, in many of the recovery packages, the main focus is an injection of funds into segments of financial sectors, not employment.

current economic downturn: as a brake on protectionist tendencies of policymakers. If a significant portion of world trade remains subject to PTAs, policymakers have little scope to increase tariffs in these areas, which could slow down the overall trend towards protectionism and avoid an all-out tariff war.

Moreover, if those PTAs had included government procurement liberalization clauses, such agreements would have provided a better tool for recovery from the current financial crisis. Unfortunately, the Asia-Pacific economies whose growth is currently under the most serious threat – that is, small, export-led low income developing economies with a significant migrant population – are also among those who have not negotiated comprehensive free trade agreements and are not signatories of the GPA. Therefore they depend on the policy choices of their trading partners with respect to keeping markets open.

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