THE LIMITED UTILITY OF BILATERAL FREE TRADE AGREEMENTS

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Bilateral free trade agreements are mushrooming all over the world. The current standstill in multilateral trade negotiations will contribute further to this trend. Since dialogue in the Doha-Round came to a halt in July 2006, bilateral agreements have received additional support. In particular, the European Union (EU) is now pushing for bilateral agreements, *e.g.* with Asian countries. The European Commission is promoting agreements with ASEAN countries, while at the same time considering negotiations on an agreement with China. The feasibility of deals with South Korea and India is also being evaluated (*Sueddeutsche Zeitung*, 11 September 2006: 25). The EU had negotiated preferential agreements for many years, but imposed a moratorium on new ones since the start of the Doha-Round. Now the forces supporting preferential deals are gaining influence. With this recent change, none of the larger economies is abstaining from preferential trade agreements. The USA, the EU, China and Japan have all stated clearly that bilateral trade agreements are an important and growing part of their trading strategies.

There is usually little debate on a Free Trade Agreement (FTA) between the largest economies, with the exception of the China-EU agreement. However, most of the deals involve a larger country and a smaller or small economy. The majority of them are asymmetrical, and this characteristic can also be found in the details of the agreements. So, with bilateral agreements, power and hierarchy return to international trade. Obviously, these dimensions were never fully absent from international economic transactions, but the development of the multilateral regime had given the weaker countries some powerful tools to underline their positions. In particular, the dispute settlement mechanism of the World

Trade Organisation (WTO) has been used by smaller countries to balance the power of America and Europe in commerce.

This article analyses the utility of bilateral trade agreements and the systemic disadvantages they have for weaker players. First, it briefly lays out the logic of bilateral trade agreements and some issues that have to be considered. Are these agreements positional goods, *i.e.* do they lose utility if more and more countries implement them? The issue of dispute settlement is discussed subsequently. The question here is whether bilateral dispute settlement is inferior to the multilateral regime. The next section looks at rules of origin. All free trade agreements require rules and certificates of origin. Without a certificate of origin, no product qualifies for duty-free access in a bilateral free trade agreement. But what exactly are the consequences of rules and certificates of origin? Are the effects symmetric, *i.e.* have the same consequences both for small and large economies? Or do they disadvantage the smaller countries?

These issues will become increasingly relevant for Australia, which has already implemented a few FTAs, the Australia-United States FTA being the most prominent one. A number of other bilateral agreements are currently being negotiated. Thus, understanding the logic of these preferential deals is important for Australia's foreign economic policy.

The Debatable Logic of Bilateral Trade Agreements

In the Asia-Pacific, the financial crisis of 1997 and 1998 continues to be a watershed. Since that crisis, the strategies for shaping external economic relations have changed, both in trade and in finance. Before 1997 the emphasis was on multilateral organisations, *i.e.* on the International Monetary Fund and on the World Trade Organisation. Today, two trends are emerging – monetary regionalism in finance and bilateralism in trade (Dieter and Higgott 2003). In trade the change is more visible than in finance, where progress to date is somewhat limited (Dieter 2005: 302-317). By contrast, bilateral trade agreements are truly mushrooming in East Asia. For instance, China has already sealed or is currently negotiating free trade agreements with 27 countries – up from zero three years ago (*Neue Zuercher Zeitung, 16* October 2006: 14).

Conventional regional integration - involving free trade areas and customs unions with more than two participating countries - is in decline in the region. APEC in particular is no longer exhibiting the dynamics of the early 1990s, being too large to be effective, and suffering from American dominance. By contrast, both bilateral trade agreements and the emerging monetary cooperation scheme in the Asia-Pacific are implemented without US participation. Notable exceptions are the Australian-American and the Singapore-US free trade agreements.

The current wave of bilateral and other preferential trade agreements is having severe repercussions for the WTO. In 2005 for the first time ever more trade has been carried out in preferential agreements rather than under the most-favoured-nation clause.[1] Article one of the General Agreement on Tariffs and Trade, the most-favoured-nation clause, has degenerated into the least-favoured-nation clause, as the American trade economist Jagdish Bhagwati has been proclaiming.[2] The EU has been the original culprit. Although it has not been implementing new free trade agreements in recent years, due to a number of initiatives, some of them overlapping, it has contributed to the undermining of the multilateral regime. As a result of the Generalised System of Preferences (GSP), the Everything But Arms (EBA) initiative, and free trade agreements, the EU trades with just eight, out of 149 WTO member countries, under the most-favoured nation clause. These are the United States, Canada, Australia, Japan, New Zealand, Hong Kong, Singapore and South Korea (World Trade Organisation 2004: 21).

Today, there are more than 300 free trade agreements and a few customs unions either already implemented or being negotiated. Until a few years ago, the entire Asia-Pacific region was not contributing to this trend. Countries like Japan and South Korea, but also Australia, were staunch supporters of the multilateral regime. This, however, has changed

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1 Whether the actual trade in the preferential agreements takes place utilizing the preferences or whether companies prefer paying the tariffs due to the complexity of rules of origin requires further analysis.

2 Although the GATT Secretariat does no longer exist and has been replaced by the WTO, the GATT treaty – in its 1994 version – continues to be the legal basis of the multilateral trading regime. The General Agreement on Trade in Services (GATS) regulates services, including financial services.

dramatically. Partly because there continues to be a momentum for bilateral agreements, and partly because some countries in the region are using these agreements to fast-forward their economic and political position in the region, no country in the Asia-Pacific is willing to abstain from the current fashion.

Ross Garnaut and David Vines have argued that the trend towards discriminatory bilateral agreements is "... an ill-thought-out early-twenty-first century response, and it is deeply disturbing" (Garnaut and Vines 2006: 2)[3]. The traditional debate on this issue has been characterised by the 'stepping-stone' or 'stumbling bloc' arguments. Bilateral or minilateral agreements could be either - contributing to improvements of the multilateral regime or undermining it. However, until today, it appears fair to say that the multilateral regime has received very little, if any, stimulus from bilateral agreements. Indeed, the current stalemate in the Doha-Round can at least partly be attributed to the existence of alternative, bilateral regimes.

Existing in parallel to the WTO, why might bilateral agreements undermine the multilateral order? One reason is that many bilateral deals contain dispute settlement mechanisms outside the WTO. Dispute settlement could continue to be conducted in Geneva, but the fact that this is not the case, in particular in agreements in which the USA participates, indicates that bilaterals are competing with, not complementing, the multilateral regime.

Bilateral Trade Agreements as Positional Goods

Bilateral trade agreements may be regarded as positional goods. Fred Hirsch (1977) defines positional goods as those that lose their utility if others are using the same good. For instance, using a motor car has a higher utility when very few others are doing the same thing. If

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3 These systemic consequences of this trend towards bilateralism are not the main focus of this current paper. For a discussion of the relationship between multilateral and bilateral regulation see Matsushita (2004: 192f).

everybody drives a car, the utility of having a car declines sharply. Positional goods are characterised by the irreproducibility of their value.

Why might bilateral trade agreements also be positional goods? If all other countries rely on market access via the multilateral regime, then a bilateral free trade agreement could be beneficial, provided that market access is unrestricted in the bilateral agreement and is more restricted under WTO regulations. For instance, if Australia were the only country that has successfully negotiated a free trade agreement with the United States, Australia would have a benefit. However, if all other WTO member countries were also to negotiate a similar free trade agreement with the US, there would not be any additional advantage from a bilateral trade agreement, whilst the disadvantages of free trade agreements would continue to exist. In other words: the more countries use bilateral agreements, the more limited is the utility of these relative to other economies. There continue to be advantages for early starters, but as other countries catch-up, the usefulness of bilateral agreements declines (Hilaire and Yang 2004: 622). The more bilateral deals are struck, the more are their preferences eroding (Dee 2005: 38). In a scenario where all WTO member countries would have implemented a free trade agreement with the US, the utility of such an agreement – compared with the multilateral alternative – would not be large. Only if the United States had a protectionist trade regime under WTO regulations, and a significantly more open bilateral regime, would there be some continuing advantage.

Bilateral Dispute Settlement

A brief look at existing bilateral agreements indicates further problems relating to dispute settlement. For instance, there have been continuing quarrels between the USA and Canada over the implementation of the North American Free Trade Agreement (NAFTA). Canada has frequently accused the US of protectionist policies in some sectors, most prominently in softwood lumber, but Canada has been unable to secure free trade within NAFTA in specific areas. For Australia, it might have been useful to consider Canada's experience with NAFTA before signing the deal with the United States.

Canada and the USA have been arguing over softwood lumber for decades. However, since 2001 the conflict has heated up. American producers of softwood lumber have argued that the fees collected by the Canadian national and provincial governments to harvest timber on publicly owned land fall below market rates and are therefore an illegal subsidy (Ikenson 2005: 1f). However, on closer inspection, it appears fair to say that Canada has vast supply of forests and that the cultivation of these forests requires little – if any – investment. The availability of large areas of forests is Canada's comparative advantage. All NAFTA and WTO dispute settlement panels that have examined the case have ruled that Canada's low stumpage fees cannot be considered a subsidy.[4]

Since 2001, the USA has collected a total of 5 billion dollars in duties from Canadian exporters. But Canadian producers have not even contributed to the improvement of America's public finance. Under the Byrd Amendment of 2000 (the Continued Dumping and Subsidy Offset Act), these sums have been distributed to American softwood lumber producers. Duties collected on the importation of Canadian softwood lumber have been used to subsidise their American competitors. The Canadian government has won several victories in NAFTA dispute settlement panels but, despite having exhausted its appeals under NAFTA, United States authorities have proclaimed that they will neither repeal nor refund the duties (Ikenson 2005: 1). Unsurprisingly, Canadian politicians have been infuriated. Prime Minister Paul Martin has branded the US position as nonsense and has called the approach a breach of faith. On 6 October 2005, he demanded the refund of the duties (Ikenson 2005: 1). However, some American politicians have not been concerned by either the NAFTA dispute settlement or by Prime Minister Martin's claim. In a letter to Commerce Secretary, Carlos Gutierrez, on 20 October 2005, 21 American Senators have called for the preservation of the duties They argued that 'NAFTA panel decisions cannot and should not force the Department to deny legitimate relief under U.S. law to the domestic lumber industry and its workers' (quoted in Ikenson 2005: 5).

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4 Canada has challenged different aspects of the lumber case in the NAFTA and in the WTO dispute settlement mechanisms.

The Canadian-American clash on softwood lumber highlights the importance of multilateral dispute settlement. Prior to the creation of the WTO in 1995, dispute settlement could be blocked by the party accused of an illegitimate policy. This has changed. Today, the WTO is one of the few multilateral organisations where small countries can take the EU or the USA to court and have a fair chance of receiving justice, if after some years. No party can block the dispute settlement mechanism of the WTO. The implementation of that dispute settlement mechanism was not only a milestone for the creation of a rules-based system of international trade, but can also be interpreted as one of the few building blocks of global governance. If anything, an expansion of the WTO's mandate could be considered a useful step.

By contrast, transferring dispute settlement to the bilateral level can be a deterioration. In many bilateral schemes, there is an option – either bilateral dispute settlement or multilateral dispute settlement. It is obvious that the bilateral route offers many possibilities for the more powerful partners to promote their case. Hierarchy and power – never fully absent in international trade – have a more prominent role in bilateral trade agreements than in the multilateral regime. The existence of an alternative to the WTO dispute settlement mechanism provides the more powerful countries with an additional choice, but for weaker countries this is a drawback.[5] In the WTO, countries can form coalitions in dispute settlement, which both reduces costs and increases the bargaining influence (Davis 2006: 7).

In NAFTA, the dispute settlement mechanism is even stricter than the one in the WTO because it provides the equivalent of domestic judicial review – in theory. In the WTO, the country that wins a dispute can either demand compensation or retaliate by imposing its own duties – which affects its own consumers negatively. In NAFTA, Canada can ask for the repayment of duties, but since the US government does not pay, the weaker partner has no policy options apart from terminating the FTA – an unrealistic option for Canada.

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5 In the European Union disputes are conferred exclusively to the European Court of justice and other EC bodies. By contrast, in NAFTA chapter 20 there is a choice of forum for dispute settlement (Pauwelyn 2003, p. 1012).

In the AUSFTA, the regulations on dispute settlement are similar to those of NAFTA. There is the possibility of monetary compensation instead of trade remedies (Dee 2005: 13). However, the NAFTA case clearly demonstrates that this potential advantage depends on the willingness of partners to accept the rules – and in the softwood lumber case the United States preferred to ignore them.

In recent years, two comparable disputes that arose between a developing country and a large economy underline the importance of multilateral dispute settlement. The first case concerns Peru, the European Union and the labelling of sardines. The EU restricted the sales of Peruvian sardines on the grounds that only the Mediterranean type is a sardine. Peru took the labelling dispute to the WTO, won the case and is now selling its sardines – labelled Pacific sardines – in the EU (Davis 2006: 22). Although Peru was the only country to file a complaint, Canada, Chile, Colombia, Ecuador, Venezuela and the United States participated in the process as observers (Davis 2006: 18). Peru won this case with legal advice from the Advisory Centre on WTO Law, which provides its service only to developing countries and received its initial endowment from nine European countries and Canada.[6]

A comparable case concerns catfish produced in Vietnam, which has had a bilateral trade agreement with the United States since 2001. With this treaty Vietnam, which is not a member of the WTO, gained MFN recognition, i.e. had access to the American market as any WTO member country. With the opening of the American market, exports of frozen catfish from Vietnam rose from 5 million pounds in 1999 to 34 million pounds in 2002. The U.S. Association of Catfish Farmers soon lobbied for restrictions on the importation of catfish (Davis 2006: 24).[7] The story proceeded in stages. First, the Vietnamese exporters were forced to rename their catfish as either basa or tra. Second, when imports did not decline sufficiently, an anti-dumping case was initiated. This caused a problem because, under U.S. law, an anti-dumping petition can only be initiated against a 'like-product'. Consequently, basa and tra were

6 See the ACWL website at *http://www.acwl.ch*.

7 The American fishermen claimed that fish from Vietnam was of inferior quality because the fish were raised in 'Third World rivers'. One fisherman even suggested that the fish could be contaminated with Agent Orange (Davis 2006:25).

converted back into catfish! Even the American Department of Commerce got confused and referred to the case as concerning "certain frozen fish fillets from Vietnam" (Davis 2006: 29). Vietnam not only lost the labelling, but also the anti-dumping case. Vietnam hired (costly) American law firms to support it but, outside the WTO and its dispute settlement mechanisms, Vietnam had no chance to receive justice.

Of course, one may argue that the USA would behave differently in the case of Australia. Unlike Vietnam, Australia has a choice between WTO and bilateral dispute settlement. But in view of these two cases, the WTO dispute settlement mechanism appears superior to bilateral deals because of greater transparency and the ability to form coalitions of like-minded countries, a view Christina Davis shares:

> Dispute settlement mechanisms in bilateral free trade agreements also have significant effects on the context for compliance bargaining between trade partners. These dispute settlement mechanisms offer some of the advantages of legal framing found in the WTO dispute settlement. Yet the WTO provides developing countries with the option to enhance their leverage through coalition action, which was important in the case of Peru. As the proliferation of bilateral free trade agreements expands the options for managing trade problems, the choice of negotiation forum will become an important first step in negotiation strategies (Davis 2006: 39).

Cumbersome Rules of Origin: New Non-Tariff Barriers to International Trade?

Another disadvantage of free trade agreements that will not disappear over time is the administrative burden that 'rules of origin' cause. In an entirely open world economy with no restrictions of the flow of goods, these rules of origin would not matter because it would be irrelevant where goods originate. Today, however, the origin of a product matters, in particular in preferential agreements.

All free trade agreements including bilaterals, require rules of origin to establish the 'nationality' of a product. The reason is that in FTAs participating countries continue to have diverging *external* tariffs. One

country might have a high tariff on, say, cars in order to protect domestic producers, whilst the other might have a low or no tariff on that product. Since only goods produced within the free trade area qualify for duty free trade, there have to be procedures that differentiate between goods produced within the FTA and goods from the rest of the world. The preferential system becomes complicated and expensive. On average, the cost of issuing and administering certificates of origin is estimated to be five percent of the value of a product (Dieter 2004: 281; Roberts and Wehrheim 2001: 317).[8]

In the past 40 years, the use of rules of origin has changed significantly. After decolonisation, many developing countries used rules of origin as instruments to enhance their economic development. Rules of origin were used to increase the local content of manufactured products and to protect the infant industries in those economies against competition from imports. This function of rules of origin is of relatively minor importance today. Rather, developed countries use strict rules of origin to protect their aging domestic industries.

When criticising the negative consequences of rules of origin, there is a caveat. By paying the appropriate tariff, they can be easily overcome. Since peak tariffs continue to cause difficulties in some sectors, the protectionist effect of rules of origin should nevertheless not be underestimated. The combination of tariffs and stringent rules of origin can be an efficient instrument for the protection of a market. One example for that approach is the textile market in NAFTA, where rules of origin require the yarn to be spun in NAFTA (the yarn-forward rule) or even the fibre to be produced in NAFTA (the fibre-forward rule), which is used for many textiles containing cotton. The consequence is that Canadian or Mexican textile producers cannot source their cotton from, say, African cotton producers, but instead have to buy cotton from US producers. Rules of origin are opaque protectionist instruments.

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8 In NAFTA, the costs of meeting rules of origin requirements have been estimated at two percent of the value of *all* Mexican exports to the United States (Dee 2005: 22).

Methods for Establishing Origin

First, it is important to understand that there are two categories of certificates of origin - non-preferential and preferential. The former are used to differentiate between foreign and domestic products, for instance for statistical purposes, for anti-dumping or countervailing duties or for the application of labelling or marketing requirements (Jakob and Fiebinger 2003: 138). The second type is the one that can distort trade because it provides preferential access to a market.

To begin with, customs regulation does not permit multiple origin of a product. Current customs regulation requires that a single country of origin is established (Jakob and Fiebinger 2003: 138). There are four methods to establish the 'nationality' of a product, to establish origin. There is natural origin and origin due to substantial transformation, this latter category being subdivided into three other forms: a change in the tariff heading, a minimum percentage of value added and specific production processes (Estvadeordal and Suominen 2003). Natural origin (wholly produced or obtained) is the least complicated approach. This applies to raw materials and non-processed agricultural products, i.e. to a relatively small part of international trade.

A change of tariff heading is already much more complicated. The Harmonized System (HS) is a set of regulations that has been agreed upon in the World Customs Organisation (WCO). It consists of 1241 categories on the four-digit level of industry classifications, and more than 5000 categories on the six-digit level. If a product receives a different tariff heading after the production process, this can be used to qualify for origin. This method has considerable advantages. It is both transparent and easily established. Using the Harmonized System is simple, easy to implement and causes relatively little cost. The necessary documentation is undemanding. The trouble is that a change of tariff heading does not necessarily constitute a significant step in the production process. Minor changes to a product can lead to a change of tariff heading. Furthermore, if a final product consist of a large number of components, documenting origin becomes complicated, and therefore costly (Woolcock 1996: 200). Therefore, merely requiring a change of tariff heading to establish origin is the exception in FTAs.

The minimum value-added rule is probably the most complicated method to establish origin. Incidentally, it is also the most widely used scheme. A certain percentage of the value of the product has to be produced within the FTA to qualify for duty free trade.

The calculation of minimum value added is difficult and varies between different free trade areas. It also varies between product categories. Furthermore, technical details have to be considered. Which methods to calculate local content are accepted? For example, are capital costs counted as local content?[9] If yes, up to which percentage? In FTAs between developing and developed countries, the lower wages in the poorer countries ironically result in a disadvantage, because the minimum value added can be reached more easily if wages are higher.

Finally, specific production processes can be identified and agreed upon in order to establish origin. The trouble is that this method both requires complex negotiations on agreed production processes and continuous updating. Due to the changing patterns of production, new forms of production emerge that would constitute substantial transformation, but unless they are listed in the catalogue of agreed production processes, they would not qualify for duty free trade.

Other free trade agreements have demonstrated how complex rules of origin can be. The NAFTA rules of origin cover more than 200 pages. There are byzantine regulations on local content, for instance a 62.5 percent local content requirement for motor cars (for more details see Dieter 2004). NAFTA regulations are important because the USA uses them as a template for its trade agreements.[10] On balance, rules and certificates of origin create arbitrary incentives that contribute to the rise, not decline, of transaction costs in international trade (Garnaut and Vines 2006: 10).

For producers, these rules of origin result in an additional administrative effort and expense rather than a facilitation of trade. An example where

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9 In NAFTA, the cost of capital for machinery can be included (Krueger 1995: 8).

10 But where the USA is not involved, rules of origin are just as complex. For example, in the Japan-Singapore Economic Partnership Agreement, the Japanese government insisted on detailed, product-specific rules of origin which cover 200 out of the 360 pages of the agreement (Ravenhill 2003: 308).

this is particularly obvious is the clothing industry in Asia. Today, state-of-the-art production chains need as little as three weeks from sample making to delivery. Production and sourcing processes are divided into up to 10 or 12 stages in various countries. This model will no longer be manageable due to the complexity of rules of origin (Dee 2005: 39). Of course, one might argue that slowing down the international division of labour is a useful development. But that is an entirely different debate: preferential trade agreements are normally justified because they are supposed to facilitate trade, rather than obstruct it.

The Cumulation of Origin

One of the most important issues for competitiveness is the question whether the cumulation of origin from different FTAs is possible. Cumulation of origin is an important exception from the principle of giving preference only to products produced within an FTA (Jakob and Fiebinger 2003: 144). The underlying question is whether in overlapping FTAs inputs can be sourced from various member countries and still achieve origin?

The European Union has been actively promoting free trade areas both with other European as well as with non-European countries. This has resulted in complicated rules of origin that potentially harm transnational production processes and could reduce the competitiveness of European manufacturers. In Europe, this awareness has led to the Paneuropean cumulation of origin. In 1997, PANEURO was established, which permits the cumulation of origin between the free trade areas of the EU and the European Free Trade Area (EFTA). PANEURO today covers as many as 50 FTAs (Estevadeordal and Suominen 2003: 16).

What is the cumulation of origin? Bilateral cumulation is the conventional version: it permits the use of intermediate products coming from the other country in an FTA. Diagonal cumulation permits the use of intermediate products from all countries that are participating in the cumulation scheme without risking origin. Diagonal cumulation can also be called the cumulation of origin between free trade areas. Full cumulation of origin is more comprehensive still, because it allows the

use of intermediate products from all countries, but this type of cumulation is rare in customs administration (Estevadeordal and Suominen 2003: 5; Priess and Pethke 1997: 782). Full cumulation would dilute any preferential arrangements, because from wherever an input would be sourced, this would count as an input from within the free trade area.

Outside Europe, hitherto there are only limited attempts to permit the diagonal cumulation of origin. To date, there are some early attempts in South-East Asia. But the rapid increase of bilateral and plurilateral free trade agreements in the region calls for a Pacific-wide diagonal cumulation of origin, if increasing welfare indeed were the main goal of the FTAs.

For companies in Australia, this poses a challenge of increasing relevance. Transnational production regularly requires the sourcing of inputs from the cheapest producer worldwide. If bilateral FTAs result in the limitation of inputs from these two countries, the consequence is potentially a welfare-reducing diversion of trade. Take the FTA between Australia and the USA. If a manufacturer in Australia will have to use intermediate products from either Australia or the USA to achieve origin, but the cheapest provider of inputs comes from, say, Thailand, this would be trade diversion. To use another example: Australian clothing manufacturers that used to source their fibre and cloth from Asian producers may have to switch to more expensive American producers in order to qualify for duty free access to the USA. Rather than using the cheapest supplier worldwide, the cheapest supplier from within the free trade area is used. In other words: trade is diverted, which results in – following conventional economic theory – a welfare reduction.

Since this rationale has to be applied for each and every individual bilateral free trade area, it is obvious that this situation undermines the competitiveness of producers in a region where free trade agreements are mushrooming. Rather than working towards the increase of efficiency, companies get preoccupied with achieving origin – a waste of time and resources.

Rules of origin, indispensable parts of free trade agreements, do not contribute to trade facilitation. Rather, they can be used as protectionist

devices. In particular, badly designed rules of origin can create barriers to intra-industry trade (Inama 2005: 577). Of course, there is considerable variation between free trade agreements with regard to the stringency of their rules of origin. But even when generous limits for establishing origin are chosen, the complex administration remains. Clearly, companies that are unwilling to meet the requirements of rules of origin can always opt out and simply pay the appropriate tariff, which in turn would reduce the utility of the free trade agreement to zero.

In summary: rules of origin and their application have to be taken into consideration when evaluating the usefulness of free trade areas. They make transnational production processes more complicated, if not impossible. The inherent need for documentation of the production process is resulting in additional bureaucratic procedures. They may also contribute to trade diversion, because manufacturers may use the cheapest supplier from within the free trade area rather than the cheapest supplier worldwide. Alternatively, they can have the effect of completely undermining the effectiveness of the trade agreement.

Australian Implications

In Australia, the Howard government has made a remarkable policy shift between 1997 and today. Whereas it emphasised the importance of the multilateral regime in 1997, it is now very actively pushing bilateral agreements. However, the earlier approach continues to be more convincing. Australia, an exporter of raw materials and agricultural products, cannot benefit very much from free trade in manufactured products unless dynamic effects would lead to an increase in competitiveness of Australian manufacturers. The country would benefit from free trade in agriculture, but the agreement with the USA has set an unfavourable precedent for other FTAs. Rules of origin disadvantage those Australian exporters that source intermediate products from efficient producers in Asia.

Australia's policy shift is rather unfortunate, because it depends on the rule of law in international relations. Australia is a country that is not

closely affiliated to any large bloc. Consequently, the country vitally depends on a functioning multilateral trading regime. Of course, if one concludes that the multilateral regime is already collapsing, then bilateral trade agreements would offer a second best solution. Australia is certainly not the main culprit, but the country's trade policy shift has contributed to a disturbing trend. Further, the limited resources that the Australian government – and most others – can provide for trade negotiations have an effect on the country's ability to push multilateral negotiations. It is an illusion to assume that both approaches can be pursued with equal vigour.

As a consequence of Howard's policy shift, the country's credibility in trade negotiations is weakened, its sovereignty reduced and the potential for Australian companies to integrate themselves in international production networks is undermined.

The bilateral route shows very few benefits for Australian commercial interests, but it has damaged the reputation of the country in international groupings. The Cairns Group is now relatively weak and major players within that organisation, Brazil in particular, are today using other fora to promote their cases, *e.g.* the G-21 founded during the failed WTO ministerial round in Cancún. Bilateral trade agreements in general and the deal with the United States in particular are not in Australia's national (economic) interest. This conclusion is also drawn by Philippa Dee, as follows:

> It is often claimed that preferential trade agreements can achieve faster progress than multilateral negotiation in difficult areas. This appears not to be the case with AUSFTA. On a strict cost-benefit calculation, the agreement is of marginal benefit to Australia, and possibly of negative benefit given some of the pernicious but unquantifiable elements of the intellectual property chapter (Dee 2005: 38).

Australia has joined the movement towards bilateral trade agreements. This trend, particularly visible in the Asia-Pacific, is difficult to comprehend. These preferential agreements are often not liberalising trade comprehensively, cause great administrative burden to producers and undermine the multilateral regime.

By and large, it is quite unlikely that Australian companies will benefit from bilateral trade agreements with other countries in the region, namely with China and Japan. For decades, despite substantial liberalisation efforts, the weakness of Australian manufacturing has not been reduced. It is hard to envisage the emergence of Australia as a manufacturing centre for Asian and world markets due to, say, a free trade agreement with China. Today, manufactured products constitute only 25 percent of Australian exports, and that category of exports tends to be liberalised in FTAs. Raw materials, the largest component of Australian exports, have usually not been affected by import tariffs, and thus nothing will change in free trade areas.

The situation might be somewhat different in services, a sector in which Australian financial companies are competitive and can probably benefit significantly from free trade. This would be particularly the case if Australia and ASEAN would agree on comprehensive free trade in goods as well as in services. However, some ASEAN countries, *e.g.* Thailand, are unwilling to open their financial sectors to foreign competition after the devastating experiences of the Asian crisis.

Conclusion

The arguments and evidence in this article show that, taken together, bilateral agreements have very few advantages. They are inferior to regulating trade in the WTO, and they not as useful as large regional agreements can be, *e.g.* the EU or ASEAN. Bilateral free trade agreements are a third-best solution for regulating international trade. They violate the normal conditions for economic efficiency and they are imbalanced, because they disadvantage the poorer players and systemically strengthen the more developed players. Of course, one can also question the need for further liberalisation of trade, but this is an issue that is hardly considered in the debates on bilateral free trade agreements.

The trend towards bilateralism is often justified with the notion that simply relying on the WTO is like doing nothing. This is not the case.

Multilateralism continues to function and to represent a superior form of regulation compared to bilateral regulation like in AUSFTA. In trade policy, pushing preferential agreements is a second-best solution, if that.

Furthermore, bilateral trade agreements contain an element of discrimination which is worrying. In the 1930s, discriminatory preferential regimes were dominating the organisation of international trade. Today, we are returning to a regime where goods originating from befriended countries have easier access to a national market than others. There is discrimination between friends and foes. The post-war trading regime had the explicit goal of non-discrimination, and today's policy makers are sacrificing this philosophy on the altar of quick, but uneven and unstainable, economic gains.

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Abbreviations

APEC	Asia Pacific Economic Co-operation
ASEAN	Association of Southeast Asian Nations
AUSFTA	Australia-US Free Trade Agreement
EBA	Everything But Arms
EFTA	European Free Trade Association
EU	European Union
FTA	Free Trade Agreement
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
GSP	Generalised System of Preferences
HS	Harmonised System
NAFTA	North American Free Trade Agreement
WCO	World Customs Organisation
WTO	World Trade Organisation

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