



CANADIAN GLOBAL AFFAIRS INSTITUTE  
INSTITUT CANADIEN DES AFFAIRES MONDIALES

## **PREFERENTIAL TRADE AGREEMENTS VS. MULTILATERALISM: IN THE NEW TRUMP-WORLD, DOES CANADA FACE AN IMPOSSIBLE CHOICE?\***

Judit Fabian

### **SUMMARY**

International trade is often framed in starkly divergent terms: either countries choose multilateral trade agreements (MTAs) and advance the cause of global economic liberalization, or they choose preferred trade agreements (PTAs) and put the entire system at risk. Canada has a long track record of pursuing PTAs and with the Trump administration's opposition to multilateralism, and longstanding opposition in elements of the Republican and Democratic parties, this trend will likely continue. The question is whether progress will come at the expense of the global trade system.

Some economists believe PTAs to be trade-diverting, reducing trade with more efficient producers outside the agreement. Others insist that PTAs can create trade by shifting production to lower-cost producers in one of the participating countries. One prominent contrary argument holds that PTAs lead to discontinuities in tariff regimes between countries and regions, increasing

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transaction costs, disrupting supply chains, creating opportunities for corruption and harming global welfare, especially in developing nations.

While debate continues about the effects of PTAs, a closer examination suggests that worries are overblown about their negative impacts on global trade flows. Evidence indicates that they support rather than harm the international trading system. Countries shut out of PTAs are more motivated to seek out agreements in new markets, increasing liberalization overall. They may also seek a reduction in most-favoured nation (MFN) tariffs, which would deprive PTAs of their major tariff benefits. Studies have found complementarity between preferential and MFN tariffs, revealing that PTAs promote external trade liberalization. Even if a PTA reduces a given country's incentive to push for multilateral liberalization, it raises the odds of that country liberalizing its trade to avoid getting left behind.

PTAs are a response to the difficulties of securing sweeping multilateral agreements. The World Trade Organization (WTO) Agreements authorize them under GATT Article XXIV, GATS Article V, and the enabling clause, and the WTO facilitates a degree of governance over PTAs through its dispute settlement process. Over the past 25 years, countries have adopted these deals at a rapid pace. Between 1994 and 2005, the number of PTAs increased from 50 to 200. By April 2018, 336 were in effect. At the same time, global trade has increased significantly. Between 1994 and 2010, the volume of world merchandise exports more than doubled. The proliferation of PTAs has resulted in a rise in international trade governance, because the countries involved shape their relationships in line with the WTO agreements. This juridification makes PTAs subordinate to the international system rather than giving them room to dissolve it. Canada should therefore have no fear of pursuing PTAs within the larger framework of the effort to achieve multilateral trade liberalization.



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## **ACCORDS COMMERCIAUX PRÉFÉRENTIELS OU MULTILATÉRALISME : DANS LE NOUVEAU MONDE DE TRUMP, LE CANADA FAIT-IL FACE À UN CHOIX IMPOSSIBLE?†**

Judit Fabian

### **RÉSUMÉ**

Le commerce international est souvent formulé en termes très divergents : soit les pays choisissent des accords commerciaux multilatéraux (ACM) et font ainsi avancer la libéralisation économique mondiale, soit ils choisissent des accords commerciaux préférentiels (ACP) et mettent l'ensemble du système en péril. Le Canada a une longue expérience dans la négociations d'ACP et, avec l'opposition de l'administration Trump au multilatéralisme ainsi que celle de certaines factions républicaines et démocrates, cette tendance se poursuivra probablement. La question est de savoir si les progrès se feront aux dépens du système commercial mondial.

Certains économistes estiment que les ACP détournent les échanges en réduisant le commerce avec des producteurs plus efficaces en dehors de l'accord. D'autres insistent sur le fait que les ACP peuvent favoriser le commerce en transférant la production vers des producteurs à moindre coût dans l'un des pays participants. Un argument contraire important soutient que les ACP

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entraînent des discontinuités dans les régimes tarifaires entre les pays et les régions, augmentent les coûts de transaction, perturbent les chaînes d'approvisionnement, sont propices à la corruption et nuisent au bien-être mondial, en particulier dans les pays en développement.

Alors que le débat se poursuit sur l'effet des ACP, un examen plus approfondi suggère que les inquiétudes quant aux effets négatifs sur les flux commerciaux mondiaux sont exagérés. Les données indiquent qu'ils permettent de soutenir le système commercial international plutôt que de lui nuire. Les pays exclus des ACP sont plus motivés à conclure des accords sur de nouveaux marchés, ce qui accroît la libéralisation dans son ensemble. Ils peuvent également rechercher une réduction des tarifs de la nation la plus favorisée (NPF), ce qui priverait les ACP de leurs principaux avantages tarifaires. Des études ont montré une complémentarité entre les tarifs préférentiels et les tarifs NPF, ce qui révèle que les ACP favorisent la libéralisation du commerce extérieur. Même si un ACP réduit l'inclinaison d'un pays donné à faire pression pour une libéralisation multilatérale, il augmente les chances de ce pays de libéraliser son commerce afin d'éviter d'être laissé pour compte.

Les ACP sont une réponse aux difficultés liées à l'obtention d'accords multilatéraux de grande envergure. Les accords de l'Organisation mondiale du commerce (OMC) les autorisent au titre de l'article XXIV du GATT, de l'article V de l'AGCS et de la clause d'habilitation. En outre, l'OMC facilite un certain degré de gouvernance des ACP grâce à son processus de règlement des différends. Au cours des 25 dernières années, les pays ont adopté ce type d'accords à un rythme rapide. Entre 1994 et 2005, le nombre d'ACP est passé de 50 à 200. En avril 2018, 336 ACP étaient en vigueur. Parallèlement, le commerce mondial a considérablement augmenté. De 1994 à 2010, le volume des exportations mondiales de marchandises a plus que doublé. La prolifération des ACP a entraîné une augmentation de la gouvernance du commerce international, car les pays concernés façonnent leurs relations conformément aux accords de l'OMC. Cette juridisation assujettit les ACP au système international plutôt que de leur donner la possibilité de le dissoudre. Le Canada ne devrait donc pas craindre de conclure des ACP dans le cadre des efforts de libéralisation multilatérale du commerce.

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Canada seems to face a choice between its multilateral tradition and the bilateral and regional present. The country has been at the forefront of efforts to create a liberalized, rules-based, multilateral trading system since the advent of the General Agreement on Tariffs and Trade (GATT) in 1947, and particularly since the advent of the World Trade Organization (WTO) in 1994. At the same time, Canada has taken its part in the proliferation of preferential trade agreements (PTAs) during the past three decades, being party to at least 14 that have come into force since 1989 (WTO 2020).<sup>1</sup> Given the extreme difficulty and length of the Doha round of multilateral negotiations, it seems probable that Canada, like other countries, will have to continue to pursue PTAs as the most certain means to achieve tangible results in trade liberalization. The Trump administration's strong preference for bilateral trade agreements and equally strong antipathy toward multilateralism constitute a powerful new influence. The question is whether, in its necessary response to these developments, Canada's efforts will have the unintended and undesirable effect of undercutting decades of progress toward the rules-based, liberalized, multilateral trading system that successive Canadian governments have supported since the end of the Second World War.

This is a question of global governance, and it is best answered not by a study of Canada's experience with trade policy, but by extrapolating from the extant literature concerning multilateral and preferential trade regimes globally. This literature demonstrates that neither empirical evidence, nor the nature and rules of the WTO system, nor the nature of PTAs, requires the sort of choice a Canadian government would justifiably fear to face. PTAs can coexist with and support multilateralism; there is no necessary dichotomy that would require a choice.

Many have strongly argued, particularly during the past decade, that PTAs<sup>2</sup> are detrimental to the WTO's regime of global trade governance. By no means is this necessarily so. In fact, the proliferation of PTAs since the WTO's advent is of profound import in the juridification of the WTO regime (Fabian 2015). The degree of this proliferation is striking. As Fiorentino et al. (2007) show, the cumulative total PTAs reported to the GATT/WTO between 1959 and 2005 did not reach 50 until 1994. Between 1994 and 2005, the number rose to exceed 200 (Bhagwati 2008, 13; Fiorentino, Verdeja and Toqueboeuf 2007). By April 2018, total PTAs in force and reported to the WTO numbered 336 (WTO n.d.).<sup>3</sup> Indeed, between 2000 and 2008, the United States alone implemented six PTAs, reached agreement upon five further PTAs and was in

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The WTO's databases of PTAs and RTAs include 13 naming Canada, plus NAFTA.

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The accepted nomenclature for differentiating between trade agreements is surprisingly sloppy. In general, the literature identifies regional trade agreements (RTAs), preferential trade agreements (PTAs) and multilateral trade agreements. Under common English usage, however, NAFTA is a preferential, regional and multilateral trade agreement because it confers preferences upon specific parties, confines itself to a specific region of the globe, and yet comprises more than two contracting parties (thus "multi"). Nevertheless, this paper follows the standard practice of economics and trade-governance literature by meaning "global" when it says "multilateral." Thus, "multilateral" refers to GATT and WTO-level agreements. Equally, the paper follows Bhagwati's practice of understanding RTAs to be a particular sub-species of PTA, and therefore of aggregating them for purposes of enumeration. The WTO, on the other hand, makes a clear distinction between PTAs and RTAs in its tables, but does not make the conceptual distinction clear and, one fears, would have difficulty doing so if it made the attempt. (Why, for example, is Australia's South Pacific Regional Trade and Economic Co-operation Agreement not an RTA, while the Canada-Ukraine FTA is?)

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The figure of 336 combines the PTAs and RTAs in the WTO table.

negotiations to reach another five (Heydon and Woolcock 2009, 269-272). This total of 16 exceeds the cumulative total reported to GATT as late as 1972 (Bhagwati 2008, 13; Fiorentino, Verdeja and Toqueboeuf 2007). During the same period of 2000 to 2008, the EU implemented 12 PTAs, reached agreement on one (implemented April 1, 2009<sup>4</sup>) (European Commission 2020) and opened negotiations on 11 more PTAs (Heydon and Woolcock 2009, 273-277). During this period, Japan implemented six PTAs, reached agreement on three, and opened negotiations on six (Heydon and Woolcock 2009, 284-286). Singapore implemented 13, concluded negotiations for two and opened negotiations for 11 (Heydon and Woolcock 2009, 287-291). Singapore's total of 26 exceeds the total cumulative PTAs reported to GATT as late as 1987, while the EU's total of 24 exceeds the GATT total as late as 1985 (Bhagwati 2008, 13; Fiorentino, Verdeja and Toqueboeuf 2007).

This level of proliferation has caused significant concern among economists such as Bhagwati, who favour a multilateral approach to trade liberalization. However, while critiques of PTAs have merit, PTAs have nevertheless been a cause of the expansion of international trade law, of increased conflict resolution by judicial means, and of more intensive legal framing. On balance, therefore, they have strengthened the regime of international trade governance under the WTO.<sup>5</sup>

The primary authorization for PTAs is found in GATT Article XXIV, which creates an exception in the GATT for customs unions (CU), free trade areas (FTA) and interim agreements meant to lead to a CU or FTA. The exception is necessary because CUs and FTAs are PTAs; they create a system of preferences that would seem to undermine the fundamental principles of non-discrimination and most-favoured nation (MFN) upon which the GATT/WTO system is based. The underlying logic of the Article XXIV exception is therefore to treat PTAs as a single political entity for trade purposes, rescuing the principles of non-discrimination and MFN status. In keeping with this logic, Article XXIV makes three basic requirements of PTAs. The first is the "internal requirement" by which "duties and other restrictive regulations of commerce" must be eliminated on "substantially all the trade" between parties to the PTA. The second is the "external requirement" by which "duties and other regulations of commerce" upon countries outside the PTA cannot be made higher than what they were before the PTA came into effect. Third, interim agreements are required to lead to PTAs within a "reasonable amount of time" (Trebilcock, Howse and Eliason 2013, 102-113).<sup>6</sup> PTAs are also permissible under GATT Article V, when the PTA involves trade in services, and under the enabling clause negotiated during the Tokyo round (1973-1979). The first important point, then, is that each PTA meeting these criteria is an affirmation of the WTO agreements

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<sup>4</sup> This was the Stabilisation and Association Agreement with Albania. Available at <https://www.consilium.europa.eu/en/documents-publications/treaties-agreements/agreement/?id=2006040>.

<sup>5</sup> It must be understood that the phrase 'under the WTO' does not imply that the WTO exerts positive control as an institution; rather, the phrase is shorthand for the trade governance regime constituted by the WTO Agreements, the WTO DSM, the continual meetings and negotiations between WTO members, and the continual work of facilitation and clarification done by the WTO Secretariat.

<sup>6</sup> "Internal requirement" and "external requirement" are the terms that Trebilcock, Howse and Eliason use.



and an extension of international trade governance under the WTO to new subject areas or levels of detail, even if only by two or three countries at a time.

The consequences of this acceptance of PTAs must be addressed in greater detail because some see them as threatening the GATT/WTO system. There are two basic debates concerning these consequences. The first is whether PTAs are trade-creating or trade-diverting. The second is whether PTAs support or impede multilateral trade liberalization. These two debates are the crux of the question concerning PTAs.

With respect to the first, the terms “trade-creating” and “trade-diverting” are taken from Viner’s classic study (1950) and used by Trebilcock, Howse and Eliason (2013, 90-1), among others (Bhagwati 2008, 17, 49-57), to consider the effects of PTAs on economic welfare. Essentially, a trade-diverting outcome is held to occur when trade increases within the PTA come at the cost of a reduction in trade with more efficient producers outside the PTA. That is, when the decrease in trade restrictions within the PTA has made it more cost effective to obtain a given product within the PTA, even if the same product can be produced at a lesser cost (more efficiently) outside the PTA. This is held to be counter to global welfare. Conversely, a trade-creating outcome occurs when trade in a given product is shifted to a lower cost producer in one of the PTA countries, whether from a higher cost producer in one of the PTA countries, or from a higher cost producer in a country outside the PTA (Trebilcock, Howes and Eliason 2013, 90-1; Bhagwati 2008, 17, 49-57).

In an idealized sense, the point of a PTA is therefore to reduce extraneous transaction costs to trade (such as tariffs, compliance costs and NTBs) and to allow the costs of production and delivery (given equal quality) to determine trade flows. The extent to which PTAs promote this ideal is the substance of the question concerning trade creation and trade diversion. It remains a question of considerable controversy and uncertainty. For example, it could be argued that the trade-diverting effects of PTAs must be relatively marginal, since about 50 per cent of international trade is MFN duty free, while a further 19.9 per cent is subject to an MFN duty of less than five per cent, and only four per cent of international trade is subject to MFN duties of 10 per cent or more (Trebilcock, Howse and Eliason 2013, 87-88). Conversely, Bhagwati (2008, 51-2) argues that comparative advantage can depend on such narrow margins that even a small trade-diverting tendency can have a significant effect upon trade flows, particularly with respect to developing economies. He further argues that even if a preference does not have an immediate trade-diverting effect, the narrowness of comparative advantage can lead to such an effect at a later time (Bhagwati 2008, 52). Thus, a trade-creating PTA today can become trade-diverting tomorrow.

Empirical data mirror the theoretical uncertainty. The 2011 *World Trade Report* (105), which took the proliferation of PTAs for its primary subject of study, states that some PTAs in some sectors have caused trade diversion, but that “it does not emerge as a key effect of preferential agreements.” Do and Watson (2006, 16) note a World Bank (2004) meta-analysis of 19 studies that shows the average effect of PTAs to be trade-diverting; however, it also shows such a diversity of results that 44 per cent of cases studied found PTAs to have a statistically significant trade-creating effect. This renders impossible any conclusion about the effects of PTAs as such. Given evidence such as the above, Trebilcock, Howse and Eliason (2013, 91) conclude that “taking the results of empirical

studies of the effects of trade flows at face value, it is unclear whether their predominant effect is one of trade creation or trade diversion.”

The idea that a given PTA is by no means necessarily trade-diverting is reinforced by Hannan’s 2016 International Monetary Fund (IMF) study, “The Impact of Trade Agreements: New Approach, New Insights,” which employs the synthetic control method (SCM) to analyze whether PTAs are trade-diverting. As Hannan writes, “for each country engaged in a trade agreement, SCM is employed to the pair representing the country’s trade with its top trading partners (top exporter and top importer separately) that are outside the trade agreement. The synthetic unit in this scenario represents the counterfactual of how trade would have evolved with the third (non-signatory) country under the absence of trade agreement. The results show evidence of slight import diversion, but not export diversion.” This paucity of a definitive effect is important because a marked tendency for PTAs individually to be trade-diverting could in turn render likely the gradual diminution, or de-juridification, of multilateral trade governance under the WTO. However, no such tendency can be discerned with confidence in a generic individual PTA; that is to say, it cannot be said to be an expected result of any specific PTA.<sup>7</sup>

The second controversy concerning PTAs is whether, collectively, they support or undermine the GATT/WTO regime and the multilateral liberalization of trade. Essentially, there are two questions underlying this debate. The first asks whether the proliferation of PTAs effectively systematizes trade diversion in accordance with Bhagwati’s “spaghetti bowl” metaphor. The second asks whether the proliferation of PTAs creates momentum toward multilateral liberalization or creates incentives against it.

Bhagwati’s (2008, 61-71) “spaghetti bowl” metaphor argues that the proliferation of PTAs causes profound discontinuity in tariff regimes between countries and between regions. According to Bhagwati, the difficulty of learning the various regimes and of adjusting business practices to the differences between them can only increase transaction costs, be trade-diverting and be detrimental to global welfare. The problem is compounded by equally disparate rules of origin among the various PTAs (Bhagwati 2008, 66-69, 120). These, he argues, greatly increase the cost of creating a global supply chain, and cause absurd judgments about the national or regional identity of particular products. Bhagwati (2008, 68) gives the evocative example of the U.S. Customs Service’s refusal to allow that Hondas produced in Ontario were in fact North American because they did not meet the requirement for 50 per cent local content. Bhagwati (2008, 70) also quotes Hong Kong businessman Victor Fung’s negative assessment of PTAs in the following terms:

Bilateralism distorts the flow of goods, throws up barriers, creates friction, reduces flexibility and raises prices. In structuring the supply chain, every country of origin

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A critic will of course note that the paucity of a definitive effect does not preclude significant and direct effects in particular given cases. This is true as far as it goes, but such cases cannot be predominant or the conclusions of Hannan, and of Trebilcock, Howse and Eliason, would have been different. Thus, it is reasonable to conclude that such regime-specific problems of trade diversion can be addressed on a case-by-case basis. Moreover, the paper’s central question is whether Canada can proceed with PTAs without fear of jeopardizing its long-standing support for multilateral trade governance. The paucity of a general effect is sufficient, on balance, to support the assertion that it can.



rule and every bilateral deal has to be tacked on as an additional consideration, thus constraining companies in optimizing production globally.

Finally, Bhagwati (2008, 66-68) notes that the ambiguities and inconsistencies in the numerous rules of origin create a wide range of opportunity for corruption. All of this is unavoidably trade-diverting.<sup>8</sup>

In response, Do and Watson (2006, 19) argue that the increased transaction costs caused by PTAs may not be sufficient to cause a significant diversion of trade. They suggest that in the process of assessing competitiveness in a given market, determining the correct tariff rate is likely to be “the easiest part of the calculation.” They argue further that the aggregate negative effect of Bhagwati’s “spaghetti bowl” must be capped by the MFN tariff rate, since producers can always revert to the MFN rate when rules of origin are too complex (Do and Watson 2006, 20).

In making this argument, they do not seem to account sufficiently for the likelihood that an aggregate negative effect would mask asymmetrical distribution. That is to say, even if a given product could always in theory be imported at the MFN tariff rate, the importer might decide to import from a different country under a different PTA where the rules of origin are clearer and the tariff lower than MFN (even if the less-clear PTA could in theory give a still-further-reduced tariff), thus rendering meaningless the theoretical possibility of the producer exporting under the MFN tariff. Equally, the same kind of trade diversion could lead a multinational corporation to alter its supply chain rather than trading under the MFN tariff. Therefore, it is by no means the case that producers can always revert to the MFN rate, since there remain the significant variables of the specific producer, product and customer that might make the reversion impossible in practice. Bhagwati would add that the asymmetrical effects of trade diversion disproportionately affect developing countries. For instance, he noted that the EU extends MFN tariffs to only six countries, including Canada, the U.S. and Japan (Bhagwati 2008, 14). This group has since been reduced to

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It is tempting here to begin a discussion of utilization rates, which, essentially, are the result of dividing actual transactions under a particular tariff regime by total eligible transactions under the same regime, whether measured by volume, value or any other unit. Thus, an example would be the number of times bananas, or auto parts or agricultural products generally, are imported from developing countries under a generalized system of preferences (GSP), divided by the total instances of the same imports eligible for the same GSP rates. The result of this calculation will always be less than one, and the rate less than 100 per cent, because sometimes the compliance costs of importing under a given tariff regime are greater than the benefit from the reduction in tariff rate.

Conceivably, then, utilization rates could serve as a measure of trade diversion, given the assumption that a rational actor will always seek to import at the lowest possible tariff rate. Leaving aside reasons of sentiment or allegiance that might render this assumption untenable, the principal difficulty with treating utilization rates as a measure of trade diversion is that preference regimes overlap. Keck and Lendle (2012) give the example of Bolivia, Colombia, Ecuador and Peru, which are the four beneficiaries of the U.S. Andean Trade Preference Act (ATPA). The same four countries can also trade under the GSP, and frequently the same product is eligible for preferential rates under both regimes. Thus, 87 per cent of imports from the four countries enter the U.S. under ATPA, and only three per cent under the GSP, apparently giving the GSP a utilization rate of only 25 per cent. However, when the 72 per cent of GSP-eligible imports that enter under ATPA are accounted for, the overall utilization rate of the two regimes together becomes 97 per cent (Keck and Lendle 2012, 8). Equally, the utilization rate for the GSP would be much higher if ATPA did not exist. This strongly suggests the difficulty and complexity of applying utilization rates to the question of whether PTAs can complement a multilateral trading system from the perspective of global governance. It can be done, but the work would be difficult, extremely detailed, careful and painstaking. It is uncertain whether such work would repay the time required by supporting conclusions sufficiently general to affect the central question of the present discussion.

five by means of the Canada-EU Comprehensive Economic and Trade Agreement (CETA).<sup>9</sup> All other countries receive tariff rates better than MFN, and would therefore stand to lose relatively more by trade diversion caused by the “spaghetti bowl” of PTAs. Thus, it seems reasonable to conclude that the proliferation of PTAs causes at least some negative effects upon global welfare, even if Trebilcock, Howse and Eliason note that there is insufficient empirical evidence to quantify or describe the negative effects in detail.

The larger question, though, is whether these effects and other aspects of the proliferation of PTAs are likely to undermine the multilateral liberalization of trade and the system of international trade governance under the WTO. Bhagwati (2008, 39, 105-108, 120) calls this the “dynamic time-path question,” asking whether PTAs are “building blocks” that accelerate multilateral liberalization, or “stumbling blocks” that delay it. If the former, present trade diversion could be accepted as a momentary cost. If the latter, the implications of trade diversion grow more severe, the discontinuity between PTAs could begin to resemble the discontinuity of the preferential system of the 1930s, and the continued multilateral liberalization of international trade could be called into question, along with prospects for international trade governance under the WTO. In short, even while a generic individual PTA cannot confidently be expected to be trade-diverting or trade-enhancing, if PTAs are collectively and systematically trade-diverting, then they can be expected gradually to undermine the WTO-led regime of international trade governance and lead to a period of de-juridification.

The theoretical literature is divided on this question. During the Uruguay round, Robert Zoellick of the U.S. State Department commented wryly that it was possible to “walk on two legs” and argued that PTA liberalization could reinforce and provide impetus for multilateral liberalization (Bhagwati 2008, 39). The empirical work of Estevadeordal et al. (2008, 5) is instructive on this point. In a study of 10 Latin American countries, they found complementarity between preferential and MFN tariffs, meaning that in their findings PTAs served as “building-blocks to external trade liberalization.” Moreover, they found that tariff reductions in PTAs induced still deeper MFN tariff reductions in sectors where WTO commitments prevented increases in applied tariffs (Estevadeordal et al. 2008, 36). Indeed, even customs unions, which do not share in the complementarity described by Estevadeordal et al. (2008, 36), were shown by Saggi et al. (2011, 37-8) to support multilateralism under certain circumstances. Specifically, they found that customs unions support multilateral trade liberalization when made between countries of relatively symmetrical endowment levels. They found the same in a hypothetical three-country grouping where one country was larger than the other two (Saggi et al. 2011, 37-8). Only when one country was smaller than the other two did Saggi et al. (2011, 38) find that customs unions hinder multilateral trade liberalization.

Along similar lines, Baldwin (1997, 878-884) theorized that trade diversion caused by PTAs would actually create ever-increasing incentives for new countries to join new PTAs, causing a domino effect that would end only with *de facto* multilateral liberalization

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Japan and the EU have negotiated an economic partnership agreement, which entered into force 1 February 2019; however, it is limited in its application to areas with EU competence (as opposed to the competence of EU member-states). <https://www.europarl.europa.eu/legislative-train/theme-a-balanced-and-progressive-trade-policy-to-harness-globalisation/file-eu-japan-epa> .

and global free trade. Conversely, Cournot oligopoly models have suggested that PTA-member welfare will peak at a point prior to universal membership, thereby suggesting that Baldwin's dominoes would cease to fall before PTA liberalization could become global liberalization (Trebilcock, Howse and Eliason 2013, 93). Squarely between these alternatives, Stoyanov and Yildiz (2014) find that between countries that are relatively politically homogeneous, and where political motivations are neither too strong nor too weak, PTAs tend to hinder multilateralism. By contrast, they also find that PTAs can serve as essential building blocks for multilateralism when they are between countries of heterogeneous political preferences.<sup>10</sup>

Another argument against PTAs is that they provide countries with a powerful BATNA, or best alternative to negotiated agreement, a concept that Odell (2000, 27-28, 52-55, 202) has used extensively in his work. A strong BATNA strengthens a given country's negotiating position by reducing its incentive to attain a given objective. Thus, the knowledge that recourse may be had to PTAs weakens the need to achieve a multilateral agreement to liberalize trade. To this, the 2011 *World Trade Report* (166) added "fear of preference erosion" and Bhagwati (2008, 87) adds "trade anxiety" and "trade fatigue" as factors caused by PTA proliferation that militate against multilateral trade liberalization.

Against these reasons, Hoekman and Kostecki (2009, 498) note that the entire purpose of the Dillon Round (60-61) was to renegotiate a balance of concessions subsequent to the advent of an unusually large PTA known as the EEC. Schott (2004, 12) argues that the most important factor is the maintenance of momentum toward trade liberalization, whether through PTAs or multilateral negotiations. In Schott's argument, this momentum will cause domestic producers to understand that their relative benefits under any given PTA will be short-lived. They will therefore use the period of preference more to restructure in order to ensure competitiveness against foreign producers, than to lobby for preservation of protection. Schott's argument thus suggests that domestic protectionist lobbies caused by PTAs might not be quite as serious a problem as Bhagwati thinks.

It is also possible, according to the 2011 *World Trade Report* (52), that the proliferation of PTAs could produce competitive liberalization, since in practice every PTA must exclude more countries than it includes. It would be reasonable for excluded countries to seek to neutralize the disadvantages they suffer by this exclusion. This could lead them either to seek new PTAs in new markets, thus increasing liberalization generally, or to seek a reduction in the MFN tariff, thus rendering PTA advantages less meaningful.

Indeed, as even Bhagwati (2008, 100) is compelled to accept, if PTAs are in fact a serious systemic concern, the reduction of the MFN tariff is a very effective and conceptually simple solution. A sufficient MFN reduction would at once deprive PTAs of their major tariff benefits. It is certainly true that the multilateral agreement necessary for MFN reduction has not been forthcoming since the opening of the Doha round in 2003, though agreements have been reached on the questions to be negotiated, on the Bali package (2013) to reduce bureaucratic barriers to trade (WTO 2013), and on the Nairobi package

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The authors do not indicate which of these scenarios occurs more frequently.

(2015) to eliminate subsidies of farm exports (WTO 2015). Nevertheless, the systemic strength of the multilateral trade regime is as much located in the ever-present possibility of enacting MFN tariff reductions as it is in their actual enactment. The proliferation of PTAs does not threaten the system's ability to reduce the MFN tariff. Seen from this vantage point, it becomes more important that even if a PTA BATNA reduces a given country's incentive to achieve multilateral liberalization, it increases the likelihood that the same country will liberalize its trade and that international trade systemically will be further liberalized. Thus, it seems more correct to suggest that the proliferation of PTAs is a periodic response to the difficulty of achieving liberalization by multilateral agreement, rather than a threat to the multilateral system, to international trade governance, to further multilateral MFN tariff reductions, or to further multilateral agreement.

Moreover, the entire purpose of the WTO and of the system of multilateral negotiations is the liberalization of international trade. It would be strange therefore if the WTO were to be undermined by the proliferation of PTAs, the cumulative effect of which is greatly to increase international trade governance, and greatly to liberalize international trade. The problem with Bhagwati's "termites in the trading system" argument is that he does not account sufficiently for the differences between the preferential system of the 1930s and the preferential agreements that have proliferated since the 1980s (WTO 2015, 7-11). The former constituted the dominant system of international trade for its time, and its ultimate effects were damaging. Irwin (2012, 101) has shown the extraordinary decline in world trade between 1929 and 1933 from US\$5.35 billion to US\$1.75 billion. The latter do not constitute a system; they are an adjunct to both the system of international trade governance under the WTO, and to multilateral trade negotiations. Moreover, far from the disastrous decline shown by Irwin, international trade has significantly increased since the WTO's advent, despite the proliferation of PTAs and despite the decline in the rate of growth in 2011 and 2012. Between 1994 and 2010, the volume of world merchandise exports more than doubled (WTO 2012).<sup>11</sup> Bhagwati too easily assumes that the two periods and their consequences are directly comparable.

There are two further reasons why the proliferation of PTAs may not be the systemic threat that some consider it to be. Every WTO contracting party that enters into a PTA does so under the auspices of Article XXIV of the GATT, Article V of GATS, or the enabling clause, and in accordance with all of the other articles and agreements incident to membership in the WTO. Should the PTA breach any of these commitments or concessions, it can be challenged through the WTO's DSM. In short, PTAs are institutionally subordinate to the system of international trade governance under the WTO; because of this, when considered institutionally, they actually reinforce and

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<sup>11</sup>

Of course the rate of growth slowed in 2011 and 2012 – it was still growth, but the world economy cannot recover from an historic global financial crisis every year, as it had in 2009 and 2010.

strengthen multilateral international trade governance under the WTO.<sup>12</sup> Properly considered, then, PTAs help to juridify the WTO system; each PTA increases, at least potentially, recourse to the DSM for conflict resolution under the WTO agreements. Moreover, each PTA is an instance of juridification as legal framing, in which two or more countries agree to define their mutual trading relationship by the terms and discourse of the WTO agreements. Thus, PTAs strengthen juridification of multilateral international trade governance, and in doing so cannot be said to undermine the GATT/WTO system, but must be allowed to have strengthened it.<sup>13</sup>

Second, there is little or no empirical evidence that the proliferation of PTAs is a systemic threat to multilateral trade liberalization or international trade governance. As Baldwin (2016, 113) states, “the rise of preferential tariffs within bilateral and regional agreements has not blocked the path to overall global tariff-cutting. Virtually all the developing-nation WTO members who engaged in bilateral, discriminatory liberalization have simultaneously been engaged in unilateral, non-discriminatory liberalization.” Moreover, as Wilkinson (2006, 69-74) has shown, every multilateral negotiation since the 1963-1967 Kennedy round has been a difficult and lengthy process.<sup>14</sup> Every round since the 1973-1979 Tokyo round has involved significant and unforeseen breakdowns and delays (Wilkinson 2006, 77-93).<sup>15</sup> Wilkinson has also shown that the kind of asymmetry produced by the proliferation of PTAs, and which Bhagwati considers so dangerous, has in fact been a feature of international trade governance since the advent of the GATT in 1947 (Wilkinson 2006, 77-93).<sup>16</sup> In that it gives the system impetus to pause and reset itself periodically, allowing a systemic response to changes in circumstance, this asymmetry can even be said to be a systemic institutional strength. Finally, international trade governance under the WTO (2012) has continued to function effectively during the long-lasting, difficult and relatively unproductive Doha round, and it rebounded with

<sup>12</sup>

It might be objected that the subordination of PTAs to WTO governance is true according to the letter of the law, but scarcely honoured in fact. It is certainly a question worth researching. For example, one could ask whether a PTA has ever been found to violate GATT Article XXIV, how rigorously PTAs are examined for compliance in moving from a sectoral agreement to covering “substantially all trade,” and whether the WTO really is notified of all PTAs. Yet even if no PTA has been found to violate Article XXIV, it hardly follows that the article is therefore ineffectual. Frequently, there are also extraneous factors that determine whether a formal dispute is begun, such as domestic political considerations, the relative power of the parties to the disagreement, and whether the PTA is part of a larger understanding covering non-trade areas such as defence and security.

Moreover, the majority of PTAs are in fact compliant with Article XXIV, whether robustly, aspirationally or as a pretence. Certainly, CUSMA, CETA, CPTPP, Canada-Chile and Canada-Israel are robustly compliant, to name only a few. Yet even the 2019 sectoral agreements between Japan and the United States, which are striking for the limitation of their scope to food and agricultural products, and to digital trade respectively, signal their intended obedience to Article XXIV by promising to expand the agreements to address remaining tariff and non-tariff barriers (United States Trade Representative, September 2019). Of course, whether Japan and the United States do so remains to be seen. If they do not, and if similar agreements of narrow scope arise and are not expanded, then it may be time to question whether the WTO’s governance of PTAs via Article XXIV exists at law but not in fact.

<sup>13</sup>

In this connection, it is especially notable that nowhere in *Termites in the Trading System* does Bhagwati mention dispute settlement or the DSM; indeed, the terms do not appear in the book’s index.

<sup>14</sup>

This is the citation for Wilkinson’s consideration of the Kennedy round, though the argument is pursued throughout this work.

<sup>15</sup>

This is the citation for Wilkinson’s consideration of the Tokyo and Uruguay rounds, though the argument is pursued throughout this work.

<sup>16</sup>

This is the central argument of Wilkinson’s monograph.

singular alacrity from the financial crisis of 2008. It cannot be maintained, therefore, that the proliferation of PTAs has constituted a systemic threat to the multilateral liberalization of trade or to international trade governance under the WTO. Indeed, rather than a systemic threat, it is much more closely in accordance with events to describe the proliferation of PTAs since 1994 as the progressive juridification of multilateral international trade governance under the WTO.

In sum, then, Canada should not fear to walk on two legs. It does not face an unavoidable existential choice between its multilateral tradition and a Trumpian bilateral present. Rather, the balance of literature strongly suggests that PTAs support, or at least do not hinder, the prospect of multilateral trade liberalization. It is likely that the proliferation of PTAs causes a measure of trade diversion; however, the extent to which this has taken place, and the extent of any damage to global welfare that it may have caused, remain largely unknown. Further, while it seems theoretically likely that the proliferation of PTAs might reduce somewhat and for a time the motivation of some countries toward further multilateral liberalization, it seems unlikely that it constitutes a systemic threat to multilateral liberalization or to international trade governance under the WTO. Instead, the proliferation of PTAs is better understood as part of the progressive juridification of the system of international trade governance under the WTO that, on balance, strengthens that system. Absent new evidence to the contrary, absent much stronger efforts by the Trump administration against multilateralism, and bearing in mind the kinds of PTAs that are more likely to hinder multilateralism,<sup>17</sup> Canada can therefore continue to pursue PTAs without undue fear that it must thereby undercut its previous work toward a rules-based, liberalized, multilateral trading regime.

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Such as customs unions between two large, homogeneous countries.



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